Euro-economics: Too much trust in redistribution

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Abstract
Favourable conditions for resource reallocation and structural economic change are needed to lift the growth and employment potential of the euro area. To create these conditions, preserving government incentives for ensuring sound public finances and structural reform is crucial. The article points to a few redistributive EU policies, in place or proposed, that are or risk diminishing market dynamics and governments’ accountability for healthy fiscal positions and economic reform. The Common Agricultural Policy hampers structural change and causes high social costs. Regional policies might be able to aid cohesion, but too many objectives, rules and monitoring requirements risk reducing effectiveness. The proposed transfers to cushion ‘asymmetric shocks’ are loaded with conceptual problems and could undermine incentives to increase economic resilience. Finally, the Commission’s proposal to create an instrument designed to financially stimulate governments to carry out reforms risks producing the opposite effect. The article concludes that these policies need revision.

Keywords
Agriculture, Asymmetric shocks, Cohesion, Safe assets, Structural reforms, Rent-seeking

Introduction
Economists would readily agree that a core mandate of the EU is to provide public goods designed to lift the union’s growth and employment potential. In particular, this comprises setting and securing appropriate framework conditions that support the functioning of the Single Market. The task is a dynamic one. The financial crisis in the euro area revealed that, under the conditions of a currency union, the EU’s regulatory infrastructure was seriously deficient in containing the risk of adverse spillovers from excessive government debt, unbalanced risk accumulation in banks’ balance sheets and...
destabilising capital flows. Clearly, much of the regulatory response to these and other challenges needs to be at the levels of the EU and the euro area.

At the same time, an enduring strand in EU policy thinking puts much emphasis on EU-level redistribution measures to bring about deeper integration, economic stability and higher growth. While redistributive policies have merit in supporting economic convergence, they can also detract from the framework conditions that are needed to reap the single market’s potential to increase employment and productivity. This potential is based inter alia on resource reallocation and structural economic change. In the same vein, it is essential to preserve government incentives for ensuring sound public finances and structural reform. This article highlights—selectively—a few EU redistributive policies, both in operation and under discussion, and argues that they need to be revised if favourable conditions for growth-enhancing economic adjustment are to be supported.

**A large part of the EU budget is inefficient: a call for change**

Big things first—and the biggest thing, at least in terms of its share of the EU budget (almost 40%), is spending on agriculture. Its largest component, 71%, is spent on direct payments to farmers, with the main purpose being to support agricultural incomes (European Commission 2018a). For comparison, direct payments to farmers are about three times as large as the UK’s contribution to the EU budget.

According to estimates by the OECD, in 2017 overall financial support for agriculture—including the subsidy equivalents of raising the price of agricultural products above world market levels—totalled 0.6% of the EU’s gross domestic product (GDP) (OECD 2018). On average, agriculture accounts for some 1.5% of EU GDP. Thus, the total subsidies amount to some 40% of the value added produced by the agricultural sector—a striking figure indeed. Of the total support accruing to agricultural producers, 20% is estimated to stem from raising prices above world market level. Correspondingly, about a fifth of the support for producers was financed at the expense of consumers. This figure does not include the consumer tax burden to finance the subsidies, nor the welfare loss implied by the impediments to structural change caused by the policies.

Since direct payments to farmers are linked to the size of farmland, they are poorly targeted in terms of income support (Matthews 2016). Also, many of the farmers have secondary incomes (and some also receive pensions and social transfers), systematic data for which are apparently hard to obtain. Independently of whether or not these features weaken the case for income support for farmers, the fact that lower farming incomes fall significantly short of higher ones can hardly be a viable justification for EU subsidies. In other sectors, unequal earnings do not trigger EU transfers. On the contrary, relative earnings act as a signal for structural change.

In recent years, a large part of the direct payments to farmers has been linked to achieving environmental goals. While this can be considered a positive development, it
is also clear that sectoral income support wrapped in environmental requirements is not an efficient substitute for policies that are genuinely geared towards protecting the environment. Indeed, as is well documented, the environmental problems caused by the agricultural sector, such as the pollution of water with nutrients and chemicals, and high emissions of greenhouse gases, are significant. Overall, the Common Agricultural Policy in its present form has high social costs, and direct payments should gradually and predictably be phased out. Dealing with income inequality should be a matter of general income taxation and social transfer systems rather than sectoral subsidies that distort the structure and the evolution of the European economy, and divert resources away from other uses.

Approximately another third of the EU budget is allocated to regional and cohesion policies (spending related to agriculture and fisheries not included). Empirical investigations into the impact of support on economic convergence are difficult, and studies show very mixed results. In an attempt to increase the effectiveness of regional support, procedures for the granting of aid have been significantly amended, linking financial support to economic performance (Europe 2020 targets) and sustainable development objectives. Moreover, some of the aid is being re-channelled to support the development of more effective administration.

These amendments might well have their benefits in supporting cohesion. However, having too many objectives, rules and monitoring requirements runs the risk of reducing the effectiveness of support, devoting a large share of resources to administrative processing and making the evaluation of policy effectiveness difficult. Procedural complexities encourage rent-seeking, and rent-seeking is synonymous with wasting resources and reducing performance. Empirical evidence shows that productivity spillovers across regions can be significant drivers of regional development (e.g. OECD 2016). This suggests that the focus of aid should be on supporting knowledge transfers, training and education, and investment in network infrastructure that is associated with positive external effects across borders (as in the areas of transport and information and communication technology).

Incidentally, it is inefficient policy to spread EU funding of local projects throughout all EU member countries, even those with a high income per capita. Is there any convincing reason—apart from obscure political economy considerations—why high-income countries should not themselves pay for domestic local spending projects that are lacking significant cross-border externalities, rather than running their funds through an EU redistribution device only to receive them back after a delay? EU regional aid should concentrate on low-income countries.

**The case for transfers to cushion ‘asymmetric shocks’ is not convincing**

The European Commission considers it necessary for deeper integration of the Economic and Monetary Union and for underlying growth to create a European fiscal capacity for
the euro area that protects countries against large ‘asymmetric’ economic shocks (European Commission 2017; 2018c). These denote cyclical fluctuations in demand that hit different countries differentially. The device proposed to provide such protection is intended to supplement national budgetary stabilisers. Two main proposals for such an instrument have been made: transfers and loans to the affected country to protect its investments against unforeseen declines in GDP, and unemployment reinsurance. The Commission links the proposals to the condition that aid must not lead to permanent transfers between states. Also, the instrument should contribute to sound fiscal policy, minimising the potential for moral hazard.

The logic behind the idea appears straightforward. In a common currency area, nominal exchange rates, differentiated by country, are no longer available to cushion country-specific external demand shocks. Nor can monetary policy be tailored to regional demand conditions. Thus, provided shocks are indeed asymmetric between countries, a common fiscal stabilisation capacity could be considered as an insurance policy, aiding the absorption of economic shocks in the countries that constitute the insurance pool.

However, a closer look raises many serious questions about the rationale behind such a device (Wurzel 2019). Business cycles in the euro area are highly synchronised. If one accepts output gaps—the difference between actual and estimated potential GDP, expressed as a percentage of (potential) GDP—as an informative measure for an economy’s cyclical position, inspection of the Commission’s current set of output gap estimates suggests that at the beginning of the financial crisis almost all euro-area countries turned within a single year from a state of over-utilisation of production capacities (in 2008) to a state of under-utilisation (in 2009). The redistribution of resources at this juncture would almost exclusively have been amongst losers. What made the economic activity ‘asymmetric’ across countries were the differences in the amplitude of GDP and in the evolution of the trend of GDP in the years following the initial output contraction. Both features relate to a large extent to the structural characteristics of the labour and product markets and to financial market regulation. What is often called an ‘economic shock’ is, in fact, a reflection of the ability of the economy (or the lack of the same) to adjust, which depends on the economy’s structural parameters. Consequently, remedies are largely a matter of structural policies rather than fiscal demand stimulus.

Transfers meant to help protect investments from cyclical downswings must, by definition, be coupled to some measure of a country’s position in the business cycle. To this end, various proposals have been made. However, it is almost impossible to differentiate between transitory and permanent ‘shocks’ to economic activity, and assessments of cyclical positions are highly volatile. Different vintages of the Commission’s estimates of output gaps for the crisis years illustrate this point. For Greece, the Commission projected in autumn 2008 that in 2009 actual GDP would exceed potential GDP by +0.7%. In 2012, the estimate for the same year, 2009, stood at -1.6%. Finally, the most recent estimate, from spring 2018, shows the output gap in 2009 at +0.5%, close to the initial projection. On this basis, a transfer in 2009 would have been judged inappropriate in 2008, retrospectively appropriate in 2012 and inappropriate again in 2018. For other
countries too, the assessment changed profoundly, in some cases including the signs of the estimated output gaps. Estimates of cyclical positions also differ significantly by approach.

This example illustrates both a lack of robust information about the appropriateness of ‘countercyclical’ transfers as well as the fact that permanent transfers cannot be ruled out by linking transfers to some measure of cyclical activity. Several further questions arise. For example, what criteria should be used when it comes to deciding which national-spending projects should be supported? And which entities should take these decisions? Due to all its ambiguities, a transfer instrument meant to compensate for ‘shocks’ would be prone to controversial disputes between governments and EU institutions once established. The existing experience with EU fiscal rules is evidence enough to make this statement almost a safe bet.

The other proposal, to reinsure countries against strong increases in unemployment, has the advantage that unemployment benefits are a major automatic stabiliser against conjunctural fluctuations, and that financial support from the euro area could kick in automatically. But would it be worth it? The proposal includes the option that governments would be able to borrow from a European fund. This is reminiscent of the federal supplementary unemployment benefit scheme in the US, under which during times of high unemployment US states can obtain federal loans to extend unemployment benefits. The loans have to be paid back. However, the US scheme cannot be taken as a model for a reinsurance system that avoids permanent redistribution: in recessions, the federal government has repeatedly funded extensions of unemployment benefits on its own (Whittaker and Isaacs 2012). In Europe, pressure for permanent funding could build up—reducing the incentive for governments to improve their economies’ resilience to unemployment problems, which is clearly a policy-related issue. Also, funding a euro-area benefit scheme might increase taxation, while allowing the scheme to be debt-financed would risk shifting government debt accumulation from the national level to the level of the euro area.

More generally, the US system of fiscal relations between the states and the federal government is sometimes referred to as evidence that fiscal governance in the euro area is deficient. In the US, the supplementary unemployment benefits paid by the federal government and the tax contributions by the states to the federal budget allow for a certain degree of inter-temporal income smoothing. Empirical investigations show that the US federal government plays a significantly larger role in smoothing private and public sector consumption in the states of the US than the EU budget does for consumption within EU countries (see, for example, Cimadomo et al. 2018). However, such a comparison would need to take into account that almost all US states have balanced budget requirements for their operational expenses, with these requirements tending to be pro-cyclical in economic downswings. Thus, transfers from the US federal government offset potentially pro-cyclical fiscal restraint at the state level. By contrast, there is nothing in the EU’s fiscal rules that would require EU-level budgetary interventions to offset pro-cyclical policies in EU member states. If general government budgets are roughly
balanced in cyclically adjusted terms, as the euro area’s Fiscal Compact requires, GDP could fall by some six percentage points below its normal-capacity level without government budgets hitting the famous 3% of GDP deficit limit.\(^1\) Moreover, in deep recessions exceptions apply that mean fiscal consolidation requirements can be waived.

Incidentally, empirical work also shows that the smoothing of private-sector incomes due to the operation of in-country automatic stabilisers (as opposed to interstate income flows) is greater on average in the euro area than it is in the US (Dolls et al. 2011). The reason for this is that, on average, unemployment benefits are more generous and income taxes more progressive in Europe than in the US.

**Reform in capital markets should continue—without policy digressions**

Perhaps even more importantly, empirical investigations in the US and elsewhere show that the largest part of interstate cyclical income smoothing in federations does not come from intergovernmental transfers but from interstate income flows transmitted via capital markets. In this respect, the euro area has turned out to be an exceptionally bad performer. Cross-border credit markets in the euro area amplified the financial crisis rather than smoothing it—with pre-crisis regulatory failures, notably in the banking sector, having played a major role in generating this negative outcome.

The corollary to this finding is that pushing for a banking union in the euro area was the right response to the crisis. The limited experience with the new institutions since then also suggests that for them to function properly some national regulations and practices will need to be adapted. In a similar vein, certain provisions for banking and capital markets at the level of the euro area will also need to be developed. Equity capital participations are a much more stable source of cross-border funding and risk sharing than bank credit. Ongoing initiatives to support the integration of equity capital markets are therefore welcome.

The preferential treatment of government debt in EU capital adequacy requirements and regulation for banks—in particular the zero-risk weighting of government debt and the lack of limits to large exposures—is still a major cause of distortions in the allocation of capital, a major impediment to long-term fiscal consolidation, and furthers the reappearance of negative feedback loops between the balance sheets of governments and banks, which amplified the crisis in the recent past. The problem has long been known: what is missing is a reliable trajectory to gradually phase out these undue regulatory preferences. A gradual and transparent phasing-out schedule would allow the banks to adapt to the new regulatory environment.

Cutting back excessive government debt levels and requiring banks to provision government bond holdings with equity capital would go a long way towards diversifying banks’ balance sheets in favour of relatively safe assets. Unfortunately the
Commission’s recent proposal to create ‘sovereign bond-backed securities’ (SBBS) looks more like a digression (European Commission 2018b). The issuing of SBBS would be based on portfolios of government bonds, and the banks’ demand for SBBS would be stimulated by extending the regulatory preferences for government debt regarding capital adequacy to SBBS. Instead of removing the regulatory bias in favour of government debt, SBBS would contribute to increasing it. At the same time, it is widely thought that SBBS might not succeed in creating a broad market for relatively safe assets. For example, Standard and Poor’s, in a preliminary assessment, suggested that the senior (low-risk) tranche of government-bonds-backed securities (the SBBS) might be rated in low investment-grade categories (S&P Global Ratings 2017). The fact that the Commission considers the common issuing of debt on the European level as a possible further step in the more distant future might also signal that confidence in the capacity of SBBS is rather limited.

SBBS are neither sufficient nor necessary for generating relatively safe assets. Instead, governments could be restricted to issuing junior bonds only—which absorb the full loss in case of a default—if the state’s structural government deficit exceeds 0.5% of GDP, which is the Fiscal Compact’s mandatory medium-term deficit limit (Fuest and Heinemann 2017). This would raise risk premiums in terms of interest rates for the issuances of highly indebted governments that continue to run high structural deficits. At the same time, there would be a greater incentive for banks to hold relatively safe bonds with low risk premiums—provided the preferential treatment of government debt in the capital adequacy regulation for banks is phased out.

**EU financial aid for reforms runs a high risk of being counterproductive**

There is widespread agreement that structural reforms in the labour and product markets, education systems, and tax and transfers systems are key to supporting higher resource utilisation, innovation and productivity growth. They can also increase resilience against economic downswings. Recognition of these links has motivated the surveillance of reforms within the European Semester, including the Macroeconomic Imbalances Procedure, even if it is less clear whether the current procedures are useful tools for fostering reform.

To supplement the European Semester, the European Commission is proposing to create a new EU financial instrument, meant to give governments financial incentives to carry out reforms (European Commission 2017; 2018d). The aid would be based on a commitment to reforms, mutually agreed between the respective government and the Commission, including timelines and milestones for the implementation of reform measures.

In trying to understand the incentive effects associated with such a funding instrument, is it far-fetched to sense that recipients might engage in rent-seeking and trying
to cash in on windfall gains? It could be even worse: what would prevent governments from being reluctant to carry out reforms unless there was ‘appropriate’ financial compensation from the EU budget? Seen from the perspective of programme administration: on what facts would the financial compensation be based? What bureaucratic procedure would be required to verify that a reforming government was not backsliding on its commitment? And if the government did let things slide, or if a successor government—acting on its election platform—repealed the reforms of its predecessor, would the country need to pay back the funds it had received from the EU?

In any case, a new layer of commitments and procedures would make economic governance in the EU even more complex than it is already. How would a new layer of transfers relate to the conditions associated with the structural and cohesion funds and other support programmes? An increasingly complex network of rules and transfers increases the odds of disputes and diverts resources to administration and rent-seeking. It has been suggested that this reform-delivery instrument would support national ‘ownership’ of reforms. How would another complicated layer of transfers from the EU foster national reform ownership?

After all, structural reform is meant to increase a country’s potential for growth and employment. What regulatory reform could be so costly that the EU would need to step in financially to create reform incentives? Frequently, the costs of reform are not monetary at all. But they might be political, as politicians might fear losing support from their constituencies. Are EU transfers meant to reduce opposition to reform amongst electorates? A more explicit earlier explanation by the Commission seems to suggest this, since it mentions as a main purpose of the funding scheme the ability to overcome the possible social and political difficulties of implementing reforms (European Commission 2013). Is there a risk that this approach could backfire amongst electorates? There are enough examples in the EU and the OECD area of governments that are willing and able to convince their constituencies about the usefulness or necessity of structural reform. Governments should reject this proposal.

**Conclusion**

Favourable conditions for structural economic change are vital for robust growth and employment. To secure these conditions, government incentives to ensure sound public finances and structural reform need to be preserved. The article highlighted some policies which need adjustment to serve this framework. The Common Agricultural Policy—the biggest single item in the EU budget—hampers structural change and has high social costs. Direct payments to farmers should be phased out. Regional and cohesion policies must not be overburdened with objectives and procedural rules. EU funding should focus on low-income countries; on fields with the highest potential to foster regional catch-up, notably training and education and infrastructure that supports positive knowledge and productivity spillovers across regions.
The proposal to create a euro-area fiscal capacity to counter ‘asymmetric shocks’ suffers from a lack of proper conditioning on cyclical developments and risks leading to permanent transfers and reducing governments’ efforts to strengthen economic resilience. At the same time, funding the instrument would burden the economy. Instead, there is a case for regulatory reform, notably in capital markets. For example, equity capital participations are a much more stable source of cross-border funding and risk sharing than bank credit; initiatives supporting the deeper integration of equity markets are therefore welcome. The preferential treatment of government securities in EU banking regulation distorts capital allocation and impedes the establishment of ‘safe assets’ in the banking sector. These regulatory preferences should gradually be phased out, allowing banks to adapt to the new regulatory environment. Governments should be restricted to issuing junior bonds only—which fully absorb losses in case of a default—if the structural government deficit exceeds the critical level specified in the Fiscal Compact. This would support debt reduction and the diversification of banks’ balance sheets towards relatively safe assets. Finally, the Commission’s proposal to create an instrument designed to financially incentivise governments to carry out reforms risks producing the opposite effect. Governments should reject this proposal.

Note
1. This follows on from Commission estimates of the semi-elasticity of the responsiveness of general government budgets with respect to variations in output gaps.

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