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The EU Budget and the Role of Public Goods

ABSTRACT

This paper argues that investing in public institutions and goods are the best tool for shielding the economy against events similar to Covid-19 because private agents cannot foresee extremely unlikely events and there are markets where informational problems are pervasive. This is even more true in a confederation such as the European Union, where the right mix of public transfers and public goods is critical in minimizing incentive problems related to consolidating the single market and European integration. The Multiannual Financial Framework 2021-27 and the Fund Next Generation are steps in this direction.

Covid-19 has wrought an economic crisis of unknown dimensions since WWII. This crisis amplifies the already high degree of uncertainty that we are facing due to rapid climate change. It is clear to all of us that our patterns of economic growth, based mostly on using energy of fossil origin, are not sustainable over time. Tackling the necessary industrial transformation to fight climate change is not easy for any country and it is a challenging task for a confederation such as the EU because the costs and benefits of altering the status quo are not equally distributed across generations, regions and over time. In addition, our economies, which are currently undergoing an enormous digital transformation, will be in a weaker state after the Covid-19 pandemic is over. For these reasons, the policies that we should implement to fight the effects of the pandemic should focus not only on stabilizing the economy but on creating conditions that ensure that the economy is set on a sustainable and robust growth path.

LESSONS FROM THE EURO CRISIS: THE IMPORTANCE OF COMMON FISCAL CAPACITY

One of the main achievements of the EU has been the single Market with its four legs: free movement of goods, services, people and capital. The economic integration fostered by the single market brings gains for all. Just to mention a figure, Campos et al. (2019) estimate that the average gains during the first 10 years of EU membership amount to 10 percent of GDP. The appreciation of these gains, however, has been overshadowed by the significant costs of the financial imbalances experienced within the EU. Economic integration gives incentives to sectoral specialization which, in its turn, makes business cycles fluctuations and financial positions across Union members more asymmetric – see, for instance, Imbs (2004); Corsetti et al. (2008); Atalay (2017); or Mongelli et al. (2020). This asymmetry should not significantly impact welfare and private consumption of households when the appropriate risk sharing mechanisms are in place. This is where the EU, especially, the EMU, has failed. There are two private channels for risk sharing: banking integration and capital market integration. By now it is clear to all of us that both channels cannot work in the absence of a common safe asset denominated in euros. The reason is that, in absence of such asset, banks can only rely on their respective country's debt and use the repo market and the interbank market for precautionary motives. This led to the "deadly embrace," as Farhi and Tirole (2018) argued, between bank debt and sovereign debt. Moreover, in absence of the common safe asset, capital markets cannot deepen and grow beyond a country frontier, which is a necessary condition for households of different countries to share risks (Bathia et al. 2019). The result was that sharing the same currency without making further progress in capital market unification and transnational integration of the banking system left countries more financially fragile and exposed to asymmetric shocks (Jaccard and Smets 2020). The ensuing crisis threatened the very existence of the common currency, as Bunnermeier and Reis (2019) explain.

The first lesson that we have learned from the euro crisis is that private risk-sharing mechanisms cannot work properly, if the underlying institution is not well designed. The faulty institution was the Monetary Union itself, since, until now, we did not have a common safe asset denominated in euros. The European Commission and the Council have both learned this lesson and for the first time in EU history, a European institution is issuing debt to finance a common expenditure, the Recovery Fund. The amount issued, 750 billion euros, however, is tiny compared to the volume that the Commission itself deems necessary to foster banking and capital market integration and, therefore, ensure financial stability (around 13 to 30 percent of the GDP of the Eurozone – see European Commission 2020).

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The emergence of true European debt gives rise to the issue of common fiscal capacity. The reason is that, as argued in Díaz (2020b), a risk-free asset is only perceived as such when it is backed by fiscal capacity. Otherwise, it becomes a bubble. Thus, the second lesson is that the fiscal capacity of the European Commission will have to be strengthened beyond the current design of the EU budget, not to finance particular expenditure programs, such as the Common Agricultural Policy (CAP), with which we may or may not agree, but to support private risk-sharing mechanisms. Otherwise, economic integration cannot progress, and the single market will be crippled. The debate is already open and, as suggested in Díaz (2020b), that common fiscal capacity should come from harmonizing corporate taxation across EU members.

LESSONS FROM THE COVID-19 CRISIS: THE ROLE OF PUBLIC GOODS AND PUBLIC TRANSFERS

The Covid-19 pandemic is a very stark example of a negative externality, such as pollution, but they have important differences. We call it pollution because of the fact that agents use clean air as an input in their economic activities for free. Thus, to restore efficiency (i.e., to cut the externality) we have to figure out the price that agents have to pay to pollute. That price should strike a balance between a clean environment and economic activity, given the constraints imposed by sustainability (this constraint has been forgotten until very recently).

Covid-19, however, is a far more complex type of externality than pollution although, hopefully, shorter lived if vaccines become widely available soon. We could think of the Covid-19 as the fact that agents use their co-workers' and/or customers' health with a positive probability, which is not known with certainty. Both polluting and infecting others may be not observable, so the regulator has to act in both cases, but the key difference is that setting a price is far more complicated in the case of the Covid-19, because health markets are plagued with severe private information problems so that learning the true marginal social cost of infecting people is very difficult. Setting a price for the externality is almost impossible in a country with a public health system, because the allocation of health care is not carried out by a price system but by queues and patient characteristics. Setting a price in a country with a private health system would amplify the already large inefficiencies of the market. This is the reason why governments do not even attempt to create a market for the coronavirus externality and resort to regulating and coordinating actions of private agents. This is why we have lockdowns and the short-run negative trade-off between health and the economy. It follows that a combination of health system capacity (particularly ICU beds) and a wide system of testing and tracing is the only feasible way of cutting the transmissions (i.e., the externality). The larger the capacity of the health system and the ability to test and trace, the smaller the short-run negative trade-off between health and the economy. Thus, the first lesson from Covid-19 is that public goods are the best way to restore efficiency when we cannot set markets for those externalities.

The other feature that has made Covid-19 so disruptive is that it is a contingency that could not be contracted ex-ante. It is a very good example of what is called "rational inattention" (Sims 2003). Writing ex-ante contracts that cover every possible contingency is extremely costly, especially when probabilities of occurrence are not well known. It could be argued, though, that by now we have more information about the pandemic and its infection probabilities so that agents could write contracts to share risks. This is almost impossible because moral hazard problems are pervasive because Covid-19 symptoms develop much later than infection occurrence. This is particularly unfortunate because the economic effects of Covid-19 are not uniformly distributed across sectors and across regions and, therefore, there is space for risk sharing (Prades Illanes and Tello Casas 2020; Díaz 2020a, 2020b and 2020c). This is why governments intervene: implementing transfers between agents to mimic in the best possible way a risk sharing mechanism. Governments are doing this in two ways: financial guarantees and tax deferrals. In both cases, however, governments are committing their fiscal capacity if firms become insolvent. Therefore, the second lesson of Covid-19 is that fiscal capacity is key to implementing the needed transfers when private risk-sharing mechanisms fails.

The third lesson of Covid-19 is that the uncoordinated national responses to fight the pandemic disrupt the single market. Coordination is key to fighting externalities. For instance, as Motta and Peitz (2020) argue, financial guarantees and tax deferral are a sort of industrial policy. Thus, differences in fiscal capacity across countries distort the level playing field in which European firms operate. This is why we need to unify programs to help solvent firms remain afloat. One such program was the Solvency Support Instrument included in the first draft of the Fund Next Generation, which however disappeared in the Council's conclusions. It could have helped recapitalize healthy companies regardless of the fiscal capacity of their governments. The programs InvestEU (public guarantees) and React-EU (public transfers) included in the Multiannual Financial Framework will fulfill that role, although not soon enough to deal with the worst consequences of the pandemic. The incoordination of actions is particularly harmful when it pertains to public action in the fight against the Covid-19. The EU4Health Program is very welcome, although its final funding is significantly lower than the Commission's initial proposal.

COMMON FISCAL CAPACITY, PUBLIC TRANSFERS, PUBLIC GOODS AND INCENTIVES

The issuance of Eurobonds and the common tax instruments needed to finance them (whether digital rate, plastics taxes or others), as well as the implementation of public transfers programs, create a moral hazard problem: some governments may feel tempted to relax their fiscal discipline, as was pointed during the European Council meeting on 27 July. This is a very reasonable fear in a confederation of countries. Persson and Tabellini (1996) studied the political-economic equilibrium of a confederation of countries that have to determine the volume of public transfers (at the confederation level) and public goods (provided at the local level) among members. The key assumption in their analysis is that public goods improve economic resilience and reduce the impact of negative shocks. Examples of such goods are infrastructures, public education, retraining and R&D.

These authors show that in the non-cooperative political-economic equilibrium of a confederation (i.e., what we would have if all decisions were made at the European Council without the check of the European Commission and Parliament) the volume of transfers is inefficiently high, whereas the number of public goods is inefficiently low because agents do not internalize the benefits they derive from public investment in other countries. The interesting thing is that the under-provision of public goods raises the political support for higher transfers, what amplifies the problem of moral hazard. The authors study two alternative institutional arrangements. In the first one, voters choose the volume of public transfers before choosing the volume of public goods at the local level. With this type of timing, agents choose a mix involving fewer transfers and more public goods, which improves welfare with respect to the non-cooperative equilibrium. This result provides a theoretic basis for the fact that the Multiannual Financial Framework is planned on a seven-year time horizon, much longer than the typical country's government budget. The third institutional arrangement studied, which results in higher welfare than in the two previous set-ups, would be to transfer to the European Commission, i.e., the common institution, the policies to facilitate transfers between citizens of different countries. In other words, to avoid moral hazard problems, policies that, until now, are in the hands of country governments should be transferred to the supranational body. The first candidate is to create a true European unemployment insurance program (Dolls et al. 2018). The SURE facility should be considered as an embryo of such a program.

The same logic that applies to public transfers should apply to public goods, particularly those that have significant increasing returns to scale and spillovers across countries; for instance, public infrastructures and investment in R&D activities. The latest developments in the Covid-19 pandemic show that that is also the case for health expenditures. Investment in these public goods should be decided at the supranational level. The European Commission is designed to be the social planner of the European Union and should be given the power to act as such.

It should be stressed that delegating these policies to the European Commission follows from the moral hazard problem created by giving it fiscal capacity. That is, fiscal capacity and "policy capacity" must work hand in hand. The corollary of this is that we need to revise and, very possibly, to reduce the scope of the principle of subsidiarity as it is a source of incentive problems in the functioning of the European Union.

THE FUND NEXT GENERATION AND THE MFF 2021–2027

The European Union faces enormous challenges in the short- and medium-term: it has to fight against the effects of Covid-19, preserve the single market, avoid a new financial and sovereign debt crisis and, on the top of that, fight climate change by promoting an inclusive green and digital transition. As I have already pointed out, Covid-19 and climate change are negative externalities that call for collective action. I think that we need to analyze the Fund Next Generation and the Multiannual Financial Framework 2021–2027 within this context.

The new organization of the budget shows the change in priorities in the Commission, which is correctly committed to investing in public goods, and promoting digital and ecological transition. This remains the case in the budget that the European Council finally approved. The size of the MMF 2021–2027 is slightly smaller than the previous one, but it is still around 1 percent of EU GDP. The question that remains is whether this is the optimal budget size given the urgency of tackling climate change and the digital transformation of the economy. In addition, the bulk of the 2021–2027 EU budget (MFF + NGEU) is allocated to "Cohesion, Resilience and Values," which accounts for 60 percent of total spending, followed by the expenditure item "Natural Resources and Environment" which comprises 20.5 percent of the total. The main programs of these two categories are transfers, as opposed to "Single Market, Innovation and Digital," which is devoted to public goods and R&D investment, amounting to around 7.9 percent of the total budget (Fuest 2021). These numbers make us wonder whether the mix transfers-public goods is "too tilted to transfer" in the Persson and Tabellini (1996) terminology. "Horizon Europe" receives less absolute funding than its predecessor Horizon 2020, which is very short sighted. Finally, we have to wait to evaluate the full development of the expected reform in the CAP in order to assess its role in the European

Green Deal and the necessary transformation of our agricultural sector.

In my view, as my theory suggests, the EU budget should give precedence to the construction of European public goods. Fuest and Pisany-Ferri (2019), in this respect, remind us that one of the first objectives of the European Community was, exactly, the construction of public goods and argue that investing in them must take precedence over the other possible objectives of the European Union. In this respect, we should see this MFF 2021-27 as a first attempt to fix faulty institutions and building common fiscal capacity.

As explained above, creating public goods and the solid design of institutions is a precondition for risk sharing and economic integration. That is, timing is key. The timing outlined in this article dictates that the first step should be building fiscal capacity so that the common institution has enough muscle to invest in common public goods. The second step is transferring to the common institution (the European Commission) those policies that need to be coordinated at the European level. In my view, this points to a European unemployment subsidy and all industrial policies. The Commission is heading perhaps too cautiously in this direction.

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