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YOUTH UNEMPLOYMENT, SOCIO-ECONOMIC DIVERGENCES AND FISCAL CAPACITY IN THE EURO AREA

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SUMMARY : Main recommendations

TO STRENGTHEN THE FIGHT AGAINTS YOUTH UNEMPLOYMENT BY USING THE CONVERGENCE AND COMPETITIVENES INSTRUMENT

- Should give priority to fight youth unemployment;
- Should be designed to give additional support to euro area member states which are making efforts to reform and invest in their economies but cannot get back to growth because they are making parallel efforts of fiscal consolidation. These countries need this additional support because they cannot use exchange rate and monetary policies, their fiscal margin is very small and they are also dealing with a financial shock (credit crunch, high public debt service);
- Should focus on capacity building involving investment, job creation, re-training and the necessary reforms;
- Should be financed by national contributions (in proportion to GDP and the position in the economic cycle) plus some new own resources.

The contractual arrangements to have access to this instrument should be aligned with a new policy mix and conditionality.

MORE BALANCED POLICY MIX AND CONDITIONALITY

- In social policy, fighting youth employment and sustaining/reforming welfare systems. Minimum wage in Germany;
- In economic policy, fostering investment, exports and sustaining internal demand;
- In financial policy, financial regulation, Financial transaction tax (FTT), improving access to credit and reduce the public debt service to reasonable levels ;
- In fiscal policy, more tax coordination and fighting tax evasion, putting the focus on the long term sustainability of the public debt/GDP ratio.

TABLE OF CONTENTS

INTRODUCTION

The euro area crisis has generated unprecedented divergences between member states, starting with spreads in public debt issuance and interest rates in private investment which were translated into divergences in investment and growth rates, followed by divergences in unemployment (particularly the youth one between 6% and 60%) and poverty rates and are leading to the rise of anti-European movements. That is why the euro area crisis, in spite of several relevant measures which were introduced and of some limited signs of recovery, can still engender a major crisis of the Economic and Monetary Union (EMU) and of European integration. It is important to replace this dynamic of divergences by a dynamic of convergences.

> "IT IS IMPORTANT TO REPLACE THIS DYNAMIC OF DIVERGENCES BY A DYNAMIC OF CONVERGENCES."

Clear reform efforts should be undertaken by the member states under difficulties, but they cannot succeed if they are not complemented by crucial reforms of the EMU in order to overcome its systemic flaws. A proper banking union and a proper fiscal union are crucial to reduce these divergences because they can reduce the differences of financing costs of private and public investment and spending, when they are no longer reasonable, which is the case now.

To understand why, we will clarify the nature of the divergences within the euro area and we will compare the EMU with other monetary areas before elaborating on the kind of fiscal union which should be developed in europe. After a brief comparison of possible instruments to build a fiscal capacity, we make some recommendations on the design of a new euro area solidarity mechanism as well as on the conditionality to be attached to it.

1. What kind of divergences do we have in the European Union and the euro area?

For a proper solution to be set up, it is important to distinguish different types of divergences we can have between European Union (EU) member states and, more particularly, between euro area countries:

- **Structural divergences** leading to asymmetric shocks hitting particular regions or counties due to their specific pattern of productive specialization. This kind of structural divergences of growth and employment will always exist due to a natural - and desirable – variety of productive specializations. In non- euro area countries, these cyclical divergences can be reduced by monetary, exchange rate and fiscal policies

  Euro area countries are particularly exposed to this kind of divergences. In the EMU, the national instruments with this purpose were reduced to a small room of manoeuvre in the budgetary policy and there are no instruments at European level. This means that if a euro area country is hit by an asymmetric shock, there are few means to avoid the social impact in terms of wage and benefit cuts and job losses;

- **Competitiveness divergences** due to different paces of economic change. The higher pressure of globalization and the need to move to a new growth model more knowledge-intensive and less carbon-intensive, adapting structures and preparing people to new jobs. This transition requires an important amount of new investments and of structural reforms in business framework conditions, labour markets, social protection, education, innovation systems. Over the last years, these competitiveness divergences between the EU member states have increased by lack of investment means and coordinated reforms, in spite of common policy guidelines and the Community budget.

  These divergences are increasing between euro area countries if they have different financial conditions to invest in this transition to a new growth model

- **Cyclical divergences** due to different unit labour costs and inflation rates combined with the same monetary policy and leading to different real interest rates. **These divergences are specific to the euro area countries;**

- **Financial divergences between the euro area countries** created by the financial crisis followed by the euro area crisis. The recent financial crisis led to a general credit crunch and magnified the macroeconomic imbalances which were already building up in the euro area. More recently, the crisis of the euro area interconnecting high sovereign debt with high bank debt has created cumulative divergences between euro area countries regarding financing conditions, investment rate, growth rate, unemployment rate and sustainability of welfare systems. The instruments which were created so far- notably the European Stability Mechanism (ESM) and the new European Central Bank (ECB) instruments - are able to reduce the divergences regarding the financial conditions, but not the other divergences regarding economic growth and the social indicators.

If these EMU flaws are nor addressed, **the most likely sequence of events will be**:

- In the most vulnerable euro area countries: important reduction of wages, social benefits first; followed by important jobs losses triggering a recessive spiral; uncontrolled emigration and human capital losses; reduction of the growth potential and rise of the public debt/GDP ratio; erosion of democratic regimes;

- In the other euro area countries, increasing pressure on their social standards; risks of social dumping; less export opportunities;

- In the EU as a whole, erosion of the existing instruments to provide a social dimension; reduction of the aggregate internal demand, shrinking the internal market; systemic pressure towards lower growth or recession; loss of political legitimacy.

2. Assessing the European Union tool box to cope with divergences

“DIFFERENT TYPES OF DIVERGENCES REQUIRES DIFFERENT INSTRUMENTS TO REDUCE THEM”

This clarification of the type of divergences is important because they will require different instruments to be reduced. The Table below takes stock of the existing and missing measures to cope with more detailed economic, social, fiscal and financial divergences:

Table 1 ► EU tool box to cope with divergences

TYPE OF DIVERGENCE	EXISTING INSTRUMENTS	INSTRUMENTS BEING DISCUSSED	OTHER PROPOSALS
Fiscal	Stability and Growth Pact (SGP) Treaty on Stability, Coordination and Governance (TSCG)		
Financial	ESM ECB	Banking Union	Euro area Debt Agency
Cyclical	ECB	Wage coordination	Economic or Unemployment Insurance Fund
Competitive	Structural Funds Reforms Coordination EU 2020	Structural Funds losses Convergence and Competitiveness Instrument	
Structural	Globalisation Fund		

3. How can we brake these divergences?

A new policy sequence is needed to brake these divergences:

- Refocusing on the comprehensive development objectives defined by the europe 2020 Strategy and to be implemented by all member states in the framework of the European emester;
- Introducing additional social indicators for macro-economic surveillance and complementing it with a social scoreboard;
- Developing a macro-economic coordination to improve the overall policy-mix with a symmetric approach (deficit and surplus countries);
- Improving the coordination of the major structural reforms;
- Improving the coordination of main priorities of economic and social policies (using the integrated guidelines);
- Improving the framework conditions for internal migrations with better social integration (portability of rights, etc);
- Developing forward-looking investments, notably social investments in training, active labour market policies, child care;
- Defining the room of manoeuvre for these investments in the investment rules of the Stability and Growth Pact (SGP);
- Improving the financial conditions for private and public investment.

Wage adjustments, job losses, migration, structural reforms but also investments, job creation and income transfers will also certainly be ingredients of the next life period of the EMU. But there is a big political choice to be made about the axis which will be preferred:

- Either a euro area of internal divergences with deep internal contrasts regarding wages, social benefits, unemployment rates and migration flows;
- Or a euro area of internal convergences, with more coordinated reforms and investments, and with upward trends in growth, employment, inclusion and social sustainability.

Nevertheless, in the current financial situation, this can only be possible **if a banking union makes real progress and if some kind of euro area fiscal capacity is defined to reduce the divergence of financing costs.** This concept of “fiscal capacity” deserves further elaboration.

4. Can monetary integration work without fiscal capacity?

What are the **basic conditions for a monetary area to work and survive?** A rich and long international experience tell us two basic conditions are required:

- sufficiently integrated markets and mobility of factors to facilitate a certain degree of convergence between the competitiveness of the member states;
- monetary integration must be coupled with a considerable degree of fiscal integration.

The current European debate recognises these two conditions but is divided about the importance to be given to the convergence objective as well as about the meaning to be given to fiscal integration:

- for some, this is just about defining and enforcing a common fiscal discipline;
- for others, this is also about coupling this common fiscal discipline with a common budget based on some common taxes and with better instruments to issue and manage public debt.

The available international experience shows that **fiscal unions** with shared currency have a basic set of similar features:

- common principles of fiscal discipline in the sub-central governments;
- in this common framework, sub-central governments enjoy different degrees of fiscal autonomy to meet their financial obligations with their own fiscal resources (when this autonomy is high, bail-outs are excluded);
- a central government with a relevant budget based on own tax resources and a Treasury responsible to issue common debt.

The **roles of this central government budget** are usually the following:

- a macro-economic stabilisation and anti-cyclical function to protect regions under asymmetric shock, whatever their relative level of wealth (richer or poorer regions);
- a redistributive function, involving a transfer of resources from more competitive and wealthy regions to less competitive and wealthy ones. A vertical fiscal imbalances (VFI) between income and spending is accepted to enable this redistribution, provided free rider and moral hazard are prevented;
- a partial mutualisation of issuing public debt if there is more mutualisation of the decision-making, notably on fiscal discipline and tax collection.

5. What Kind of Fiscal Capacity is needed in the EMU?

The fiscal union in the European Economic and Monetary Union has precise principles of a common fiscal discipline, but:

- its macro-economic stabilisation function remains very weak, because its instruments at national level are now reduced to very a tight fiscal room of manoeuvre and they are not complemented by instruments at European level;
- it is silent about the need of a euro area budget and its possible roles. The discussion about equipping the euro- area with some kind of "fiscal capacity" has just started;
- it is still incipient about the possible ways to mutualise risks and decision-making about debt issuance. The European Stability Mechanism is used to issue euro-bonds at small scale but the discussion of conditions to issue euro-bonds at larger scale is being postponed.

In the meantime, the EU Community budget plays an allocative and re-distributive role involving all EU member states but only at a small scale.

In order to reduce dangerous internal divergences, the EMU should be equipped with (1) a stronger instrument to stabilise the re-financing costs of public debt and (2) a proper fiscal capacity for macroeconomic stabilisation and able to promote catching-up by focusing on capacity building.

6. Building up a EU fiscal capacity

The Table below identifies possible instruments to build up this fiscal capacity. Some of them already exist, others are simply proposals being tested in the European debate.

Table 2 ► Possible instruments to build up a EU fiscal capacity

ROLES	SCOPE	INSTRUMENTS	CONDITIONALITY	FINANCING	MANAGEMENT	FUNDING APPROACH
EU allocation:EU Programmes EU redistribution and reform incentives: Structural Funds	All EU member states	EU Community Budget	Excellence of projects europe 2020 priorities Structural reforms	National contributions+ EU own resources	European Commission Council European Parliament	Projects Institutions
EU Micro-economic stabilisation	All EU member states	Globalisation Fund	Restructuring project and social plan	National contributions+ EU own resources	European Commission Council European Parliament	Projects
EU Microeconomic stabilisation	All EU member states	Youth Guarantee+ Youth Initiative	Youth unemployment above treshhold	National contributions+ EU own resources	European Commission Council European Parliament	Projects Institutions
EU Macro-economic stabilisation	Euro area member states	Euro area Economic Stabilisation Fund	Output gap	Euro area national contributions/ own resources	National Parliaments/ euro Group In the Council and EU Parliament	National institutions
EU Macro-economic stabilisation	Euro area member states	Euro area unemployment insurance	Unemployment rate above treshhold	EU taxes with tax neutrality	Eurogroup In the Council and EU Parliament	Individual EU citizens
Sovereign debt crisis management	Euro area member states	ESM, European Stability Mechanism	Fiscal consolidation Structural reforms	Euro area national contributions	Eurogroup European Commission	National Institutions
Reprofiling past excessive national public debt	Euro area member states	Euro area Redemption Fund	Fiscal consolidation Structural reforms	Euro area national contributions	Eurogroup European Commission	National Institutions
National public debt management	Euro area member states	European Debt Agency	Fiscal consolidation Tax harmonisation	Euro area national contributions	Eurogroup European Commission	National Institutions
EU debt issuance + EU Taxes collection	Euro area member states	Euro area Treasury	National fiscal discipline Partial transfer of collecting and borrowing power	EU taxes eurobonds	Euro area Goverment eurogroup in the Council and in the European Parliament	EU institutions
euro Area budget : Macro- economic stabilisation, EU taxes collection	Euro area member states	Euro area budget	National fiscal discipline Partial transfer of tax collection, borrowing and spending power	EU taxes eurobonds	Euro area Government Eurogroup in the Council and in the European Parliament	Projects EU citizens

In this framework, the current discussion on a new solidarity mechanism as requested by the European Council and a CCI, Convergence and Competitive Instrument as proposed by the European Commission should be based on some preliminary clarifications.

A CONVERGENCE AND COMPETITIVENES INSTRUMENT (CCI)

- Should give priority to fight youth unemployment
- Should be designed to give additional support to euro area member states which are making efforts to reform and invest in their economies but cannot get back to growth because they are making parallel efforts of fiscal consolidation. These countries need this additional support because they cannot use exchange rate and monetary policies, their fiscal margin is very small and they are also dealing with a financial shock (credit crunch, high public debt service).
- Should focus on capacity building involving investment, job creation, re-training and the necessary reforms
- Should be financed by national contributions (in proportion to GDP and position in the business cycle) plus some new own resources, notably FTT

The contractual arrangements to have access to this instrument should be aligned with the new conditionality and policy mix.

7. Rebalancing the conditions to get financial support

"CONDITIONS NEED TO BE RE-BALANCED IN ORDER TO CREATE A REAL OPPORTUNITY FOR RECOVERY AND A SOUND FISCAL CONSOLIDATION"

The conditions to have access to this euro area fiscal support are supposed to be defined by country specific recommendations and eventually specific contractual arrangements. **These conditions need to be re-balanced** in order to create a real opportunity for recovery, also indispensable to have a sound fiscal consolidation.

Some lessons should be learned from the impact of imbalanced conditionality and policy-recommendations so far. In several member states job creation was replaced by a powerful job destruction process. Viable companies, viable jobs and key skills are disappearing because:

- the access to credit to invest is unaffordable;
- export opportunities in the European single market are decreasing because of recession;
- internal demand is shrinking due to deep wage cuts, social cuts and high tax increases;
- Public investment is also very limited, even to provide the co-financing for structural funds.

This job destruction process is being ignored by the current interpretation of the scoreboards of key-indicators of the Stability and Growth Pact, the macro-economic surveillance and the europe 2020 strategy country-specific recommendations. A country can be considered a success case of adjustment if its current account becomes positive and the public deficit is somewhat reduced, even if its unemployment rate and its public debt/GDP ratio are increasing sharply.

In order to des-activate this job destruction process, we need:

- more balanced European objectives and guidelines: we should start by recalling the full range of the europe 2020 Strategy objectives;
- a more balanced scoreboard of follow-up indicators: unemployment rate should also be complemented by youth unemployment, poverty rate, household disposable income, interest rates for SMEs credit should be added;
- a more balanced interpretation of this scoreboard;

- more balanced governance: combining ECOFIN with EPSCO and COMPETITIVENESS Council view points; enhancing the role of social partners;
- more balanced country specific recommendations, taking into account the following concerns:
    - ◊ to avoid public spending cuts when they destroy growth potential and deepen the recessive spiral;
    - ◊ to avoid tax increases which are socially unfair and deepen the recessive spiral;
    - ◊ to avoid wage cuts when they do not increase employment but rather decrease the internal demand;
    - ◊ to reassess current accounts improvements when their rebalancing is combined with much higher unemployment;
    - ◊ to re-assess fiscal consolidation when the public debt/GDP ratio is increasing.

These are the kind of remarks which should be discussed in the dialogue between Social ministers and Finance ministers in order to build up a more balanced policy framework. PMs should also use them to strike the right balance between fiscal consolidation and growth. They should be reflected in more balanced country-specific recommendations, which will frame the national policies and the national budgets. Otherwise, European integration will be criticized by more and more European citizens.

8. An alternative policy-mix

It is urgent to define an alternative policy mix, which can then be adapted to each particular case.

So far, the central objectives have been to reduce the public deficit and the current account deficit. This has been achieved by public spending, social benefits and wage cuts as well as by reducing capital inflows. As this is reducing internal demand faster than exports, this is pushing GDP downwards, raising unemployment and poverty rates and worsening the public debt/GDP ratio.

In alternative, we could consider reducing unemployment and poverty as the central objectives alone. Nevertheless, is spite of sustaining internal demand, this would involve a high risk of worsening the public deficit and the public debt /GDP ratio as well as the current account deficit, leading to increasing difficulties of re-financing this country.

A more effective alternative should focus on growth, job creation and fiscal consolidation as central and combined objectives. In this case, reducing the public and the current account deficits are less relevant in face of other key-priorities

NEW POLICY MIX AND CONDITIONALITY

- in social policy, fighting youth employment and sustaining/reforming welfare systems. Minimum wage in Germany.
- in economic policy, fostering investment, exports and sustaining internal demand
- in financial policy, financial regulation, FTT, improving access to credit and reduce the public debt service to reasonable levels
- in fiscal policy, more tax coordination and fighting tax evasion, putting the focus on the long term sustainability of the public debt/GDP ratio

Nevertheless, this alternative and more effective policy-mix cannot be implemented without equipping the Economic and Monetary Union with new instruments which were discussed above.

CONCLUSION

Youth unemployment is now a central problem for many European countries. The European Union has recently made a commitment with a youth guarantee to be translated by national plans and complemented by a youth initiative to be financed by structural funds. They will mainly focus on labour market policies and in education and training. This is a relevant step, but this will not be enough to cope with the scale of the problem if the overall policy mix is not shifted towards more growth, investment and jobs creation and if the financing costs of investment are not reduced by new instruments to be developed to complete the EMU: banking union and a proper fiscal capacity.

Only these kind of instruments can reduce the scale of socio-economic divergences which are now undermining the eurozone and the European integration. This paper has proposed a more precise analysis of these divergences and of the possible instruments to build a fiscal capacity. It concludes with a practical proposal to be considered by the European Council.

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