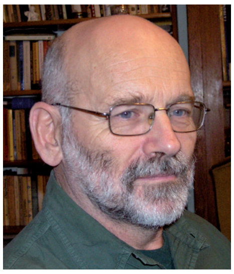

What kind of fiscal union?

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The sovereign debt crisis in Europe brought back a debate on the lacking components of the European integration, particularly on the role of fiscal integration. Both advocates and sceptics of the common currency argue that successful monetary integration must go hand in hand with a fiscal one and the deficit of the latter makes eurozone vulnerable to various shocks.

Is the eurozone really so unique?

Some authors suggest that the Economic and Monetary Union (EMU) represents a unique historical case of common currency area with decentralized fiscal policies[1]. The same argument has been raised by the European Commission in its *Blueprint for a Deep and Genuine EMU*[2].

However, historical analysis of monetary unions does not support such a strong opinion. Apart from historical episodes when monetary unification follows a political one (often involuntary) there are also examples of voluntary monetary unions of sovereign states, when common currency and central bank are not accompanied by meaningful delegation of political sovereignty in other areas (like fiscal policy) to a supranational entity.

For example, the West African Economic and Monetary Union (WAEMU) or Central African Economic and Monetary Community (CEMAC) have virtually no political and fiscal integration but they use a common currency (CFA franc) for almost 70 years. Only recently their member countries started to develop other segments of economic integration, ie, custom unions, common markets and some soft forms of supranational macroeconomic policy coordination and fiscal surveillance but the actual progress to date is rather limited, especially in case of CEMAC. Nevertheless both monetary unions proved sustainable, despite numerous asymmetric shocks, political and violent conflicts both internal and regional, limited trade and financial integration, etc.

If we broaden definition of monetary union by including a permanently fixed exchange rate (against other currency or common metallic standard), we obtain more cases when monetary 'federalism' has not been accompanied by the political and fiscal one. This concerns, in first instance, the period of the international gold standard in the second half of the 19th century and beginning of the 20th century when most of independent (and sometimes politically antagonist) countries shared the same monetary rules and, in fact, remained in a quasi-monetary union.

Arguments in favour and against fiscal integration

Even if monetary union does not necessarily require the existence of fiscal union there may be other arguments in favour of closer fiscal integration within the EU and EMU: pooling resources to carry out common policies and provide supranational public goods as suggested by the theory of fiscal federalism. Thus the discussion on fiscal integration in Europe should start from functional analysis aimed to identify those policy areas and public goods where centralization of competences and resources could either offer increasing returns to scale or help addressing cross-border externalities.

Financial market regulations and supervision, pan-European deposit insurance and bank resolution mechanism (with consequences in terms of greater centralization of public resources) are candidates number one in the sphere of economic policy. However, 'banking union' should not be limited to EMU because its main justification relates to completing the single market of financial services. As long as regulatory and supervisory power and crisis resolution resources remain in national hands the EU financial market will face danger of fragmentation and renationalization, especially in time of financial distress.

Going beyond economic sphere one can find more areas of potential benefits coming from centralization of decision making and pooling fiscal resources, for example, common defence and security policy, protection of external borders, consular services and environmental policy. However, economic rationale of centralization will have to be always confronted with political considerations such as national sovereignty concerns, interests of incumbents on a national level, and limited appetite for cross-border fiscal redistribution. As result, the EU has been historically built around the principle of subsidiarity enshrined in Article 5 of the Treaty on European Union (TEU). According to this principle, the functions of higher levels of government should be as limited as possible and should be subsidiary to those of lower levels.

The EU fiscal federalism in place

Despite opinions on the total absence of fiscal integration within the EU/EMU there are already several components of genuine fiscal union in place, ie, the EU budget, the newly created off-budget bailout facilities, EU's own revenue sources, fiscal rules and their surveillance. Ironically, quasi-fiscal operations of the ECB since May 2010 also add to the complex picture of fiscal federalism in the eurozone.

The size of EU budget oscillates around 1% of EU's Gross National Income (GNI). Its expenditures must be closely matched by revenues. The EU is neither allowed to borrow nor cumulate budget surpluses (the latter must be returned to member states). However, in the Multiannual Financial Framework (MFF) for 2014-2020 there will be possibility to move unspent money between budget lines to finance other underfunded commitments in a given fiscal year.

The EU budget in its current structure is dominated by cross-country transfer programs such as the Common Agriculture Policy, cohesion and structural funds. Financing European public goods such as research or environmental programs plays a secondary role. This is result of strong path dependence, ie, impact of the past decisions which, in turn, resulted from necessity to reach compromise on some key integration steps. Adoption of the MMF requires unanimous decision of all member states what additionally narrows room for any radical change in the budget size and its expenditure structure.

The above picture has changed with creation of the European Financial Stability Facility (EFSF) in 2010 replaced by the European Stability Mechanism (ESM) in 2012. The ESM's lending capacity is €500 billion, and the combined lending ceiling of EFSF/ESM is set at the level of €700 billion (ESM, 2013), ie, ca. 5 and 7% of the eurozone's annual GDP respectively (it is the accumulated stock while the size of EU budget represents an annual flow).

Only the 'traditional own resources', ie. 75% of custom duties on imports from outside the EU and sugar levies can be considered as a sort of EU 'federal' taxation. The two other

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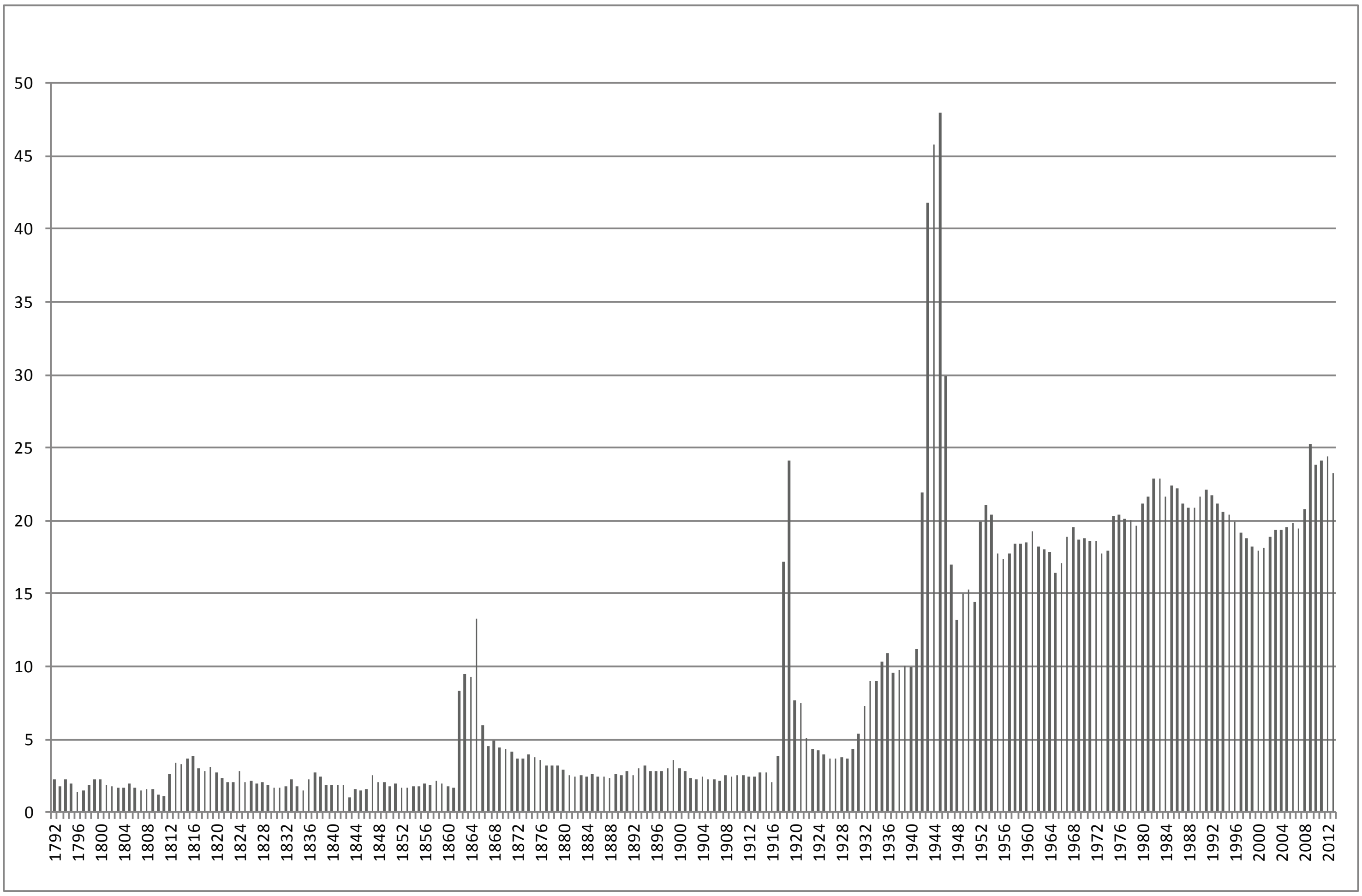
Figure 1: US total federal spending as % of GDP, 1792-2012



Source: http://www.usgovernmentspending.com/spending_chart_1792_2013USp_13s1li011mcn_F0f_Spending_In_20th_Century 'own resources', ie. from value added tax (VAT) and the one based on GNI are calculated according to complicated country-specific formulas. In addition, some net donor member states (the UK, Sweden, Netherlands, Germany, Austria) enjoy individually negotiated rebates.

Any substantial increase in the size of the EU budget in future will require developing direct revenue sources such as pan-European taxes. In turn, this will have to increase the role of the European Parliament, as the direct representation of EU citizens.

If one looks for historical comparison, the US federal budget in peace time amounted to 2-3% of GDP until beginning of the 20th century (Figure 1) and started to grow substantially only after the Great Depression in 1930s. Before adoption of the 16th Constitutional Amendment in 1913 which allowed for introducing federal income taxation, the tax power of the US federal government had been limited to collection of import tariffs and part of excises.

Fiscal discipline vs. fiscal solidarity

Fiscal discipline is critically important within federations and closely integrated economic blocks, due to intensive cross-border spillovers, more opportunity to free ride at the cost of neighbours, and moral hazard problem (expectation of bailout). It may be ensured by market mechanism (danger of sovereign default) and formal fiscal rules, or combination of both as in the case of EU. The former has been built around the 'no bailing out' clause in the Article 125 of the Treaty of the Functioning of the European Union (TFEU) and ban on debt monetization by the ECB and national central banks (the Article 123 of the TFEU). Fiscal rules have been imposed by both the Article 126 of the TFEU, the accompanying Protocol No. 12 and EU's secondary legislation, ie. the Stability and Growth Pact (SGP). They include numeric criteria on the maximum fiscal deficit and debt level backed by administrative and financial sanctions, ie, the Excessive Deficit Procedure (EDP).

Financial markets never seemed to take seriously the 'no bailing out' clause as demonstrated by very low yield spreads prior to the 2008/2009 global financial crisis, in spite of big differences in fiscal positions of individual member states. And they proved right because this clause was de facto suspended with granting balance-of-payment support to Hungary, Latvia and Romania in 2008-2009 and first aid package to Greece in 2010. It has been replaced by policy of conditional bailout, ie, financial assistance in exchange for country's commitment to fiscal adjustment and necessary reforms.

Fiscal rules imposed by the TFEU and SGP have been also frequently breached with no serious sanctions. The situation did not improve after the 2008/2009 global financial crisis, despite their serious reinforcement. The SGP includes now automatic and meaningful sanctions, especially in respect to EMU members. EU legislation also obliges member states to enhance their national fiscal rules and institutions. The new fiscal rules are backed by the intergovernmental Treaty on Stability, Coordination and Governance in the Economic and Monetary Union.

Difficulties with rules enforcement originate from continuous fiscal imbalances in many EU countries. Most of them continue to be subject of the EDP what makes them reluctant to impose a peer pressure on other 'brothers in trouble'. As result, the Commission's deadlines to bring countries' fiscal positions back under the TFEU and SGP targets are frequently postponed and no financial sanctions have been ever adopted.

Worrisomely, the Commission's *Blueprint for a Deep and Genuine EMU* suggests further weakening of market discipline by creation of the European Redemption Fund. Simultaneously, the Commission would like to strengthen its prerogatives to monitor national budgets, including veto power in respect to national budget decisions. This would make EU fiscal rules increasingly intrusive and rather incompatible with the political and legal architecture of the EU (a sort of limited federation or confederation based on the principle of subsidiarity).

Two radical ideas floated in the public debate - debt mutualization (eurobonds) and lender of last resort for governments, ie, unlimited and unconditional commitment of the ECB to purchase debt instruments of eurozone governments in case of market distress - would mean moving from conditional towards unconditional fiscal and monetary bailouts. Both are presented as the attempt to arrest irrational behaviour of financial markets, avoid cross-country contagion, and help to survive temporary illiquid but fundamentally solvent governments. Unfortunately, intentions staying behind these proposals are naïve, difficult to operationalize in practice (for example, distinguishing illiquidity from insolvency) and largely ignoring a moral hazard problem. If implemented such proposals would lead to deeply dysfunctional fiscal union.

Sadly this part of the debate on the EU/EMU fiscal federalism ignores other countries' lessons. For example, the US federal authorities did not bailout any state since 1840s and this consequent practice remained the strongest incentives for states to adopt their own constitutional guarantees of fiscal discipline. The similar 'no bailing out' practice governs the Canadian federation. On the other hand, those federal countries like Argentina and Brazil which failed to ensure fiscal discipline of their subnational governments and provided them with bailouts suffered serious fiscal and monetary stability problems on a federal level. ■

1. For example, Bordo, MD, Markiewicz, A, Jonung L: A Fiscal Union for the Euro: Some Lessons from History, NBER Working Paper, No. 17380, September 2011

2. Communication from the European Commission, COM(2012) 777, November 28, 2012.