Center for Social and Economic Research

Marek Dabrowski

What kind of fiscal union is needed within the EU and EMU?

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Key issues to be discussed

- Various meanings of fiscal union
- Interrelations between monetary union and fiscal union
- Arguments in favor and against fiscal integration
- The size of EU budget and its revenue sources
- Tax harmonization
- Mechanism of fiscal discipline vs. mechanism of mutual insurance and financial help in time of distress
- Conclusions related to the debate on fiscal integration within the EU and EMU

Various meanings of fiscal union

- No single definition of fiscal union
- Various practical meanings in the context of EU debate:
  - Centralization of fiscal resources on a supranational level
  - Supranational income sources (taxes)
  - Harmonization of taxation/ entitlements
  - The single mechanism of fiscal discipline on national level
  - Fiscal solidarity in time of distress/ bailout/ debt mutualization
  - Building institutions with fiscal authority on a supranational level (some symbolic proposals like creating EU’s MoF)

Interrelations between monetary and fiscal union

- Both advocates and opponents of the Euro project claim it must be accompanied by a fiscal and political union
- However, this is not obvious on both theoretical and empirical ground
- The OCA theory may be interpreted in two ways: (i) cross-country transfers are needed to cushion consequences of asymmetric shocks or (ii) substantial national fiscal capacity and buffers should be retained to respond to such shocks (in the absence of monetary accommodation)
- Historical and monetary examples of monetary unions without fiscal and political union: Latin Monetary Union, gold standard, WAEMU, CAEMC, unilateral dollarization/ euroization, currency boards
- Frequent comparison of the EU/EMU with the US disregards historical evolution of the latter and all characteristics of US fiscal federalism
- In fact, most of monetary unions of sovereign states have had no fiscal component

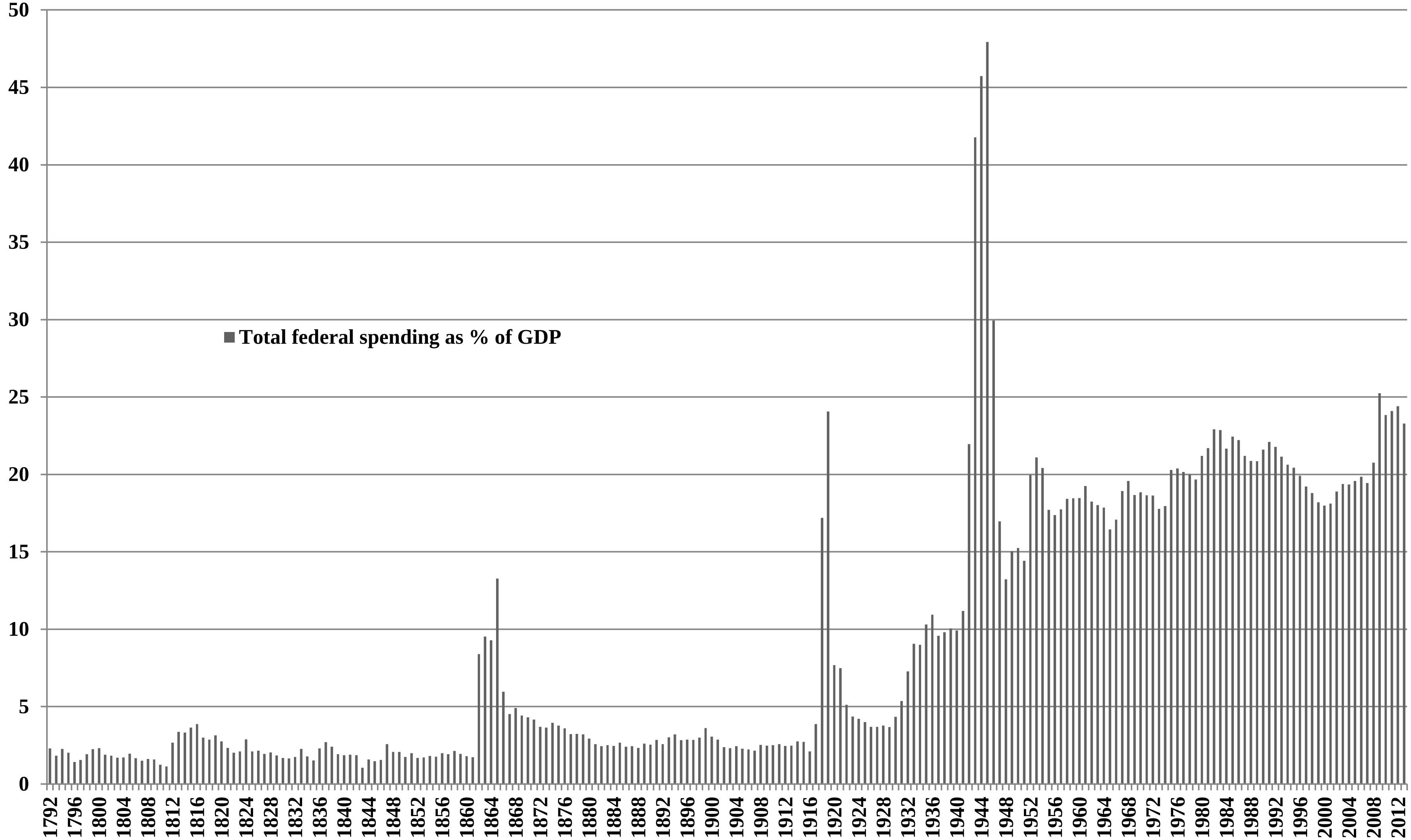
Arguments in favor and against fiscal union

- The main argument in favor of fiscal union: pooling resources to carry out common policies and provide supranational public goods
- Economic criterion of selecting policies/ public gods to be centralized: (i) increasing returns to scale; (ii) addressing externalities (functional analysis based on theory of fiscal federalism – see CEPR, 2003)
- Political considerations: national sovereignty concerns, interests of incumbents on national level (e.g., building the EBA), limited appetite for cross-border fiscal redistribution (the case of redistributive programs/ mechanisms; the same phenomenon within some national states in respect to cross-regional transfers)

The size of EU budget and its character

- The size of EU budget: 1% of GDP + newly created bailed out facilities. It is largely concentrated on redistribution (CAP, cohesion and structural funds, bailout facilities)
- The US federal budget: 2-3% of GDP until the WWI (in peace time) concentrated on provision of federal public goods (almost no redistribution)
- Several areas where common EU policies based on pooled resources would be potentially beneficial (financial sector supervision and resolution mechanisms, defense, foreign policy, joint border management, etc.) but political obstacles

US total federal spending as % of GDP



Source: http://www.usgovernmentspending.com/spending_chart_1792_2013USp_13s1li011mcn_F0f_Spending_In_20th_Century

The EU budget: sources of revenues

- Largely countries' contributions negotiated within MTBF (for 7-year period); decision requires unanimity
- As result - bias towards redistribution rather than financing European public goods and low transparency
- Own sources (custom duties and part of VAT revenue) – marginal importance
- No Union-wide entitlement system
- Hypothetical increase in size of EU budget would require more Union-level revenue $\Rightarrow$ increasing role of the EP
- Until the 16th Constitutional Amendment (1913) very limited tax power of US federal government (import tariffs and excises)

Tax harmonization on national level

- Purpose: elimination of the Single Market's internal barriers rather than fiscal considerations
- Equal level playing field and transparency vs. tax competition
- Limited – only VAT and excise tax (within broad band)
- Discussion on CIT (harmonization of tax base or tax rates)
- US: low degree of harmonization of subnational taxes

Fiscal discipline on national level

- Purpose: avoiding cross-country financial turbulence (caused by sovereign insolvency), moral hazard and free riding
- Instruments: fiscal rules and sanctions for breaching rules (problematic within the EU: the role of MS in taking Union-level decisions, difficulty to reduce substantially MS sovereignty)
- After 2008/2009 strengthening fiscal rules and hypothetical sanctions but their enforcement remains problematic
- The strongest incentive: danger of sovereign default – ‘no bailing out’ clause (Art. 125 of the TFEU)

Fiscal solidarity in time of distress

- Originally: very limited (BoP support to non-EMU member states)
- Since 2010 several bailing out facilities: Greek Loan Facility, EFSM, EFSF, ESM
- Discussion on debt mutualization (Eurobonds)
- Purpose: assistance to temporary illiquid but solvent countries against strong set of conditionality, avoiding cross-country contagion and banking crisis
- The US does not have a mechanism of bailing out states or other sub-national governments

Fiscal solidarity mechanism in practice

- Wrong assumption: some countries insolvent (Greece)
- Gradual erosion of aid conditionality
- Increasing uncertainty about quality of bailing out assets
- Quasi-fiscal involvement of the ECB
- De facto suspending Art. 125 of the TFEU
- Danger of moral hazard (national governments and private creditors) , markets play for subsequent bailouts
- Bad experience with sharing fiscal responsibility within national states
- Political setback: increasing redistribution conflict between member states

Conclusions (1)

- Not obvious that monetary union requires fiscal union
- Elements of fiscal union already exist in the EU/ EMU
- More fiscal centralization may be justified by increasing returns to scale and externalities on the EU level
- More fiscal centralization will require EU taxes and increasing political power of the EP
- Tax harmonization – the issue related to SEM rather than fiscal rules and policy
- Importance of stronger fiscal rules backed by automatic and painful sanctions (e.g. suspending voting rights in the Council)

Conclusions (2)

- Rebalancing fiscal rescue mechanism to eliminate moral hazard and return to Art. 125
- Sharing fiscal responsibility (Eurobonds) should be avoided (danger of moral hazard)
- The above conclusions apply to all EU members not only the Eurozone
- Ideally, reforming/ deepening European fiscal federalism should involve all EU member states and use community method rather than concluding new intergovernmental agreements formally outside the EU (decreasing transparency and effectiveness of EU governance)