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Fiscal or Bailout Union: Where Is the EU/EMU's Fiscal Integration Heading?

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Abstract

The European debt crisis triggered a debate on the lacking components of the EU and EMU integration architecture. Many believe that a common currency requires closer fiscal and political integration as a condition for its survival. This opinion is not necessarily supported by the experience of other monetary unions, especially those created by sovereign states. On the other hand, the current EU integration architecture already contains several elements of fiscal union. Furthermore, in several important policy areas such as financial supervision, defense, security, border protection, foreign policy, environmental protection, and climate change, the centralization of tasks and resources at the Union level could offer increasing returns to scale and a better chance to address pan-European externalities. This applies to the entire EU, not only to the Eurozone.

Each variant of fiscal integration must be based on sound foundations of fiscal discipline. Market discipline, i.e., the danger of sovereign default, supplemented by clear and consistently enforced fiscal rules is the best solution to this problem. Unfortunately, since 2010, the 'no bail out' principle has been replaced by a policy of conditional bailout of governments in fiscal trouble. Some proposals, such as Eurobonds or the lender of last resort to governments, go even further in this direction, and threaten to build a dysfunctional fiscal union.

1. Introduction

The sovereign debt crisis on the periphery of the Economic and Monetary Union (EMU) and the danger of at least a partial disintegration of the Eurozone has brought back a debate around the lacking components of the European integration. This debate has emerged on various occasions in the past, for example, during the negotiation of the Maastricht Treaty and before launching the EMU (late 1980s and 1990s) or during work on the so-called Constitutional Treaty in the first half of the 2000s. One of its dimensions is related to the role of fiscal integration, particularly within the common currency area (CCA). Furthermore, most participants of this debate assumed, in our opinion, correctly, that greater fiscal integration would also mean more political federalism at the European level (including its institutional dimension like a greater role for the European Parliament) because fiscal policy historically belonged to the core responsibilities of sovereign nations and their democratically elected legislatures.

In particular, the debate on the Euro project has continuously asked the question of how much political federalism and fiscal centralization is needed to ensure sustainable monetary integration. The argument about a 'twin' integration, i.e., a monetary integration going hand in hand with a political one, have been raised in academic debate by both advocates of the common currency (who consequently proposed to advance political union or at least the so-called economic government – see e.g. De Grauwe, 2006; Alphandery, 2012) and its skeptics who have doubted whether truly federal solutions might ever be feasible in a Europe dominated by the tradition of sovereign nation states (e.g. Feldstein, 1997; 2012). The same approach is very much present in the official document on a 'Deep and Genuine EMU' published by the European Commission (2012), which proposes directions of deeper economic, fiscal and political integration seen as a remedy to the Eurozone financial and economic crisis.

Yet, when one looks more closely at both the empirical experience of various monetary unions and the theory of an optimum currency area (OCA), the 'twin integration' argument becomes less obvious; at least it deserves careful consideration before being accepted as *a priori* paradigm. It appears that the debate on the interrelation between monetary and political integration/fiscal federalism has often been too general and superficial and lacking sufficient clarity to be instrumental for discussing and elaborating concrete institutional solutions. In particular:

- It tends to overlook those elements of a fiscal union which are already in place in the European Union (EU) and the EMU institutional architecture, of which there are quite a few.
- It is one-sided in the sense that it concentrates on the role of fiscal union as the safeguarding mechanism of successful monetary integration while it disregards other potential rationales for fiscal integration such as the implementation of common policies and projects at the EU level, the provision of European public goods, or safeguarding the Single European Market (in particular, its financial market segment).
- Most suggestions of further fiscal integration are rather general and do not specify which particular elements and mechanisms should be added to the existing integration architecture and how those new elements can ensure a greater sustainability of monetary integration.
- It lacks a sufficiently broad comparative and historical perspective. For example, the frequently used comparison is with the US but most of the arguments overlook the process of historical evolution of the US federation. Other historical and contemporary experiences of monetary unions, heterogeneous in their economic and political architecture and operational details (see e.g., Deo, Donovan & Hatheway, 2011), are rarely analyzed.
- It frequently ignores elementary lessons which can be drawn from both the theory and practice of fiscal federalism, especially in respect to the danger of moral hazard and free riding behavior arising from having the wrong incentives in place.

This paper is going to fill in at least some of the above-mentioned gaps and discuss the rationale for a pan-European fiscal union and its various components in a more systematic way.[1] In particular, we are going to analyze the following issues:

1/ The definition of a fiscal union and identification of its various components

2/ The interlinks between a monetary union and fiscal union, in particular, the extent to which the stable monetary union requires far-going fiscal integration

[1] An earlier version of this paper was presented at the 10th Euroframe Conference on Economic Policy Issues in the European Union on '*Towards a better governance in the EU?*' in Warsaw, May 24, 2013. The current version largely benefits from discussions held at this conference and from post-conference comments provided by Joshua Aizenman, Jorgen Mortensen and Luca Barbone. However, the author accepts sole responsibility for the content and quality of this paper as well as the presented opinions, conclusions and recommendations which reflect his personal views and not necessarily those of CASE.

3/ Other arguments in favor of fiscal integration (other than the interlinks between monetary and fiscal union)
4/ The size of the EU budget, its revenue sources, and decision making mechanisms
5/ The mechanism of fiscal discipline based both on market incentives and formal fiscal rules
6/ Practical conclusions to the debate on fiscal integration within the EU and EMU (including the question of which elements of fiscal integration should apply only to members of the EMU and which to the entire EU)

We start by defining a fiscal union (Section 2) and then we analyze the interrelations between monetary and fiscal unions (Section 3), which are some of the central issues investigated in this paper. This is followed by a discussion of other potential arguments in favor of closer fiscal integration, besides those justified by a common currency (Section 4). The next three sections analyze the size of the EU budget, its structure and the mechanism of its adoption (Section 5), its revenue sources and EU tax policy (Section 6) and institutional setup within the EU executive body, i.e. the European Commission (Section 7). Section 8 addresses another key issue of the EU/EMU fiscal federalism, i.e., the mechanism of fiscal discipline at the national level. Finally, Section 9 presents the conclusions of our analysis.

2. Various practical meanings of fiscal union

Unfortunately, there is no single and clear-cut definition of a fiscal union in economic literature. More interestingly, many of the authors who advocate building a fiscal union within the Eurozone (e.g., Marzinotto, B., Sapir, A. & Wolff, G., 2011) do not offer an explicit definition. In the current debate on the causes of the European debt crisis and possible remedies, various practical meanings of fiscal union are assumed by individual authors depending on their personal/ institutional views and opinions and which particular issues their analyses focus on. Thus, in various proposals related to changes in EU/EMU governance architecture, the notion of fiscal union may involve:

- a higher degree of centralization of fiscal resources at the Union level
- the development of European revenue sources for the EU budget (instead of the contributions of member states)
- a harmonization of taxation/ entitlements within the EU/EMU
- a mechanism of fiscal discipline at both the Union and national levels, including the mechanism of orderly sovereign default

- the build up of Union-wide insurance mechanisms against financial turbulences (bailout facilities), including a debt mutualization mechanism
- the creation of institutions with fiscal authority on a supranational level (for example, creating an EU/EMU Ministry of Finance)

In our opinion, all of these proposals constitute elements of fiscal union, which can be defined, in very broad terms and for the purposes of this particular analysis, as the integration of national fiscal policies at the EU/ EMU level.

However, such a general definition does not determine *a priori* which degree and forms of fiscal integration can be beneficial for the EU/EMU as a whole and individual member states and can help avoid financial distress in future or minimize its negative impact. In the subsequent sections we will try to discuss arguments both in favor and against various dimensions of fiscal union and analyze the degree of complementarity between them.

3. Interrelations between monetary and fiscal union

In the debate on the current debt and financial crisis in the EMU, both supporters and opponents of the Euro project agree it must be accompanied by a fiscal and political union in order to survive. However, while the former (e.g. Wolff, 2012; De Grauwe, 2013[2]) believe this is both possible and desirable, the latter (e.g. Feldstein, 1997; 2012) doubt it will ever happen due to a long historical tradition of sovereign nation states in Europe.

Unfortunately, the arguments in favor of political and fiscal integration as the condition for the monetary union's sustainability are rarely provided. More frequently, especially in the current crisis-dominated hot debate, they are taken as given. As a result, the claim for political and fiscal union sounds more like a creed rather than something based on well-founded academic arguments[3].

[2] De Grauwe (2013) presents himself as a skeptic of the common currency project in 1990s. However, as dismantling the Eurozone now would mean '…*profound economic, social and political upheavals throughout Europe,*' he is in favor of building a fiscal union to supplement the lacking component of monetary integration.

[3] De Grauwe (2006), who offers an in-depth discussion on interrelations between monetary and political/ fiscal union, and Aizenman (2013), who underlines the importance of a banking union (with its fiscal implications) for the stability of a common currency, are prominent exceptions here.

Furthermore, a closer examination of the interlinks between monetary and fiscal union on both theoretical and empirical ground provides us with a more nuanced picture.

According to the OCA theory as developed by Mundell (1961) and McKinnon (1963), which serves as the key theoretical framework for analyzing the economic rationale of a monetary union, fiscal policy can cushion the consequences of asymmetric shocks in cases where free mobility of production factors (labor and capital) is not sufficient to do so.

However, this part of OCA theory may be interpreted in two ways: either as the retention of fiscal capacity and sufficient fiscal buffers in territories participating in CCA to enable them to respond to idiosyncratic shocks in a decentralized way (in the absence of monetary accommodation) or the necessity to arrange centralized fiscal transfers between respective territories. The first interpretation was behind the original design of the Maastricht Treaty and the Stability and Growth Pact (SGP) (see Mortensen, 2004; De Grauwe, 2006). The second one seems to dominate in the post-2010 debate (e.g., Wolff, 2012) and the official proposals of reforming the EMU's governance architecture (e.g., European Commission, 2012).

Empirical analysis of historical and contemporary cases of monetary unions also provides us with mixed results. It is true that most historically known CCAs have matched with the territory of sovereign states, either unitary or federal. Furthermore, most historical episodes of monetary unification followed political unification, which was in most cases involuntary, being the result of war, conquest, colonization, etc. Nevertheless, there are also examples of the voluntary monetary union of sovereign states, i.e. when a common currency unit and common central bank are established, but are not accompanied by a meaningful delegation of political sovereignty in other areas (like fiscal policy) to a supranational entity and building a political superstructure[4].

For example, the West African Economic and Monetary Union (WAEMU) or Central African Economic and Monetary Community (CEMAC) have virtually no political or fiscal integration but they have used a common currency (the CFA franc) since 1945, i.e., for almost 70 years. Only at the end of the 1990s did member countries of both monetary unions start to develop other segments of economic integration, i.e., custom unions, common markets and some soft forms of supranational macroeconomic policy coordination and fiscal surveillance, following the EU/EMU experience. However, the pace of those integration processes is rather slow,

[4] Please note that in the contemporary world, no country enjoys full sovereignty and each form of international cooperation (explicit or implicit) involves some limitations on national sovereignty.

especially in the case of CEMAC. Nevertheless, both monetary unions have proved sustainable so far in spite of numerous asymmetric shocks (see IMF, 2013 for a contemporary analysis of the WAEMU challenges), violent political conflicts (both internal and regional), limited trade and financial integration, etc.

Other contemporary examples of monetary unions with no or weak political integration components include the Eastern Caribbean Currency Union and the Common Monetary Area in Southern Africa.

If we broaden our definition of monetary union by including permanently fixed exchange rate regimes (against other currency or common metallic standard), we obtain more cases in which 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 the beginning of the 20th century, when most independent (and sometimes politically antagonistic) countries shared the same monetary rules and, in fact, remained in a quasi-monetary union (see Eichengreen, 1998; Cesarano, 2009).

Summing up, monetary unions between sovereign states or within relatively loose political federations or confederations are not a new phenomenon and the EMU is not as unique a historical case as suggested by some authors.

For instance, Bordo, Markiewicz & Jonung (2011, p. 26) claim that "*The euro area is the first case in the history of monetary unions where monetary policy-making is centralized under one central bank while fiscal policy-making is decentralized in the hands of the national governments of the member states. This institutional framework is new for economists and policy-makers alike.*"

Somewhat surprisingly, the European Commission (2012, p. 2) presents a similar opinion: "*The EMU is unique among modern monetary unions in that it combines a centralised monetary policy with decentralised responsibility for most economic policies, albeit subject to constraints as regards national budgetary policies. Unlike other monetary unions, there is no centralised fiscal policy function and no centralised fiscal capacity (federal budget)*". Perhaps these are just examples of 'Europe's centrism' in the perception of economic history and contemporary experience.

What may be more important but is rarely explicitly discussed, the EMU seems to be unique in terms of the depth of its monetary, financial and trade integration and the sophistication of its financial sector,[5] which makes it different from monetary unions in Africa and the Caribbean region. Also, the scale of international capital flows has increased in recent decades as compared to the era of the international gold standard.

Even taking into account the potential EMU specifics, historical and contemporary lessons of other monetary integration projects cannot be ignored and can broaden perspective of the debate on the future of the EMU. Unfortunately, most of the available comparative analyses concentrate on comparing the EMU with the US, sometimes selectively and not always with due attention to the historical evolution of the US federation. Today's United States of America represent a mature and quite centralized form of federation but it took almost two centuries to get to this stage (Aizenman, 2013). Looking back, until the 1930s, the US was much less politically, fiscally and financially centralized.[6]

While the comparison of EMU with the US has some merit due to their similar sizes and development levels, the experiences of other federal states, sometimes less centralized fiscally than the US (for example, Canada or Switzerland – see Bordo, Markiewicz & Jonung, 2011; Wolff, 2012), may broaden the debate on the perspectives of EU/EMU fiscal integration, not to mention the experience of monetary unions of sovereign states, which seem to be the most relevant to this debate but which are largely ignored.

4. Arguments in favor and against fiscal integration

Even if a monetary union does not necessarily require the existence of a fiscal union as discussed in Section 3, there may be other arguments in favor of closer fiscal integration within the EU and EMU, such as pooling resources to carry out common policies and provide supranational public goods. This leads us to the theory of fiscal federalism which helps us understand "*which functions and instruments are best centralized and which are best placed in the sphere of decentralized levels of government*" (Oates, 1999, p.1120).

[5] These arguments have been raised by Aizenman (2013). The European Commission (2012) also makes reference to the negative consequences of the 'renationalization' of the financial sector and the financial market within the EMU as a result of the financial crisis.
[6] A comprehensive and well-balanced analysis of the evolution of fiscal federalism in the US since the Revolutionary War is presented by Henning & Kessler (2012)

Thus, the discussion about the perspective of closer fiscal integration in Europe should start from a functional analysis aimed at identifying those policy areas and public goods where the centralization of competences and resources could either offer increasing returns to scale or help address cross-border externalities[7].

While building a complete list of tasks which could be centralized is beyond the agenda of this analysis, we can mention some policy areas where a transfer of competences and resources to the European level offers potential benefits. Financial market regulations and supervision, pan-European deposit insurance and crisis resolution mechanisms in the case of bank failures seem to be the number one candidates in the sphere of economic policy. And such an integration has obvious fiscal consequences in terms of the greater centralization of public resources at the European level.

Interestingly, the idea of a 'banking union' has broad support in the context of the debate on strengthening the Eurozone institutional architecture and is seen as an important measure to save the common currency (see e.g. Aizenman, 2013; European Commission, 2012). However, in our opinion, its main rationale relates to completing the single market of financial services, which will face a continuous danger of fragmentation and renationalization (especially in a time of financial distress) as long as regulatory and supervisory power and crisis resolution resources remain in national hands. For this reason, the 'banking union' should not be limited to EMU members (the biggest EU financial center, the City of London, is located outside the Eurozone) and should not necessarily engage the European Central Bank (ECB) whose jurisdiction is limited to the EMU[8].

Some authors (e.g. De Grauwe, 2006; Wolff, 2012) also suggest conducting supranational countercyclical fiscal policy based on the findings in fiscal federalism's literature which tend to assign this function to the federal level (see Oates, 1999; Begg, 2009; Bordo, Markiewicz & Jonung, 2011). Leaving aside the discussion on the effectiveness of countercyclical fiscal measures (especially discretionary ones) in smoothing the business cycle in an open economy and against various political traps (see Dabrowski, 2012), one may agree that they have more of a chance to work at the supranational level than the national level due to collective action problem, the risk of free riding and cross border 'leakages' of demand (Dabrowski, 2010). On the other hand, it would require building a much bigger fiscal capacity

[7] The examples of such analyses are provided by Berglof et al. (2003) and Wyplosz (2007)
[8] Another argument against mandating the ECB with the banking supervision task relates to its potential conflict with the price stability mission (see Cukierman, 1996).

at the European level (probably in the range of at least of 10% of the Union's GDP), including far-going tax, social transfers and other expenditure responsibilities.

Not only is such a far-going fiscal centralization politically unrealistic in any foreseeable future (also within the EMU), but it may also be economically dysfunctional. First, it can contradict the basic principle of fiscal federalism, i.e. assigning responsibilities to the level of government which can most effectively carry out a given task. Taking into consideration the internal political, economic, social and cultural diversity of the EU, the optimal degree of its fiscal centralization may be lower than other 'mature' and more homogenous federal states. Second, taking into consideration the remaining huge productivity differences across the EU centralization of social and income policies (one of the most frequent federal mandates which is often the reason for the substantial size of federal budgets and their countercyclical capacity) may lead to the excessive convergence of labor and social costs and, as a result, make the labor market even more rigid than it is now.

For example, Wolff (2012), who supports the idea of moving part of the countercyclical fiscal policy from the national to the Eurozone level, including the creation of a Eurozone budget in the range of 2% of GDP, recognizes the risks associated with building a single unemployment insurance system within the Eurozone. Some risks are also seen by Dullien & Fichtner (2013), who strongly advocate such a common unemployment insurance scheme.

In most historical cases, the countercyclical role of the federal budget has come as a result of the prior centralization of various responsibilities: public pension systems, unemployment benefits, deposit insurance, federal infrastructure projects, and general public services (which include defense, public order, foreign policy, public health, education, justice administration, federal taxation, etc.), rather than building explicitly countercyclical fiscal facilities.

Interestingly, in the debate on a 'Deep and Genuine EMU,' the political appetite for transferring more responsibilities (and accompanying resources) from the national to the Union level seems to be very limited apart from the idea of a 'banking union'[9]. Instead there is a proposal to build a centralized Eurozone fund which would provide member states with automatic but temporary fiscal transfers in the case of adverse idiosyncratic shocks (repaid in

[9] Which also raises a lot of resistance at the national level, especially those components which may involve fiscal redistribution (a European deposit insurance system or single resolution mechanism).

'good' times), a kind of a countercyclical insurance mechanism (Wolff, 2012; European Commission, 2012).

This is a highly controversial idea[10] founded on some doubtful if not naïve assumptions. The first question is how often EMU economies experience asymmetric business cycles and suffer from idiosyncratic supply shocks which, according to the OCA theory (see Section 3) can provide justification for such transfers[11]. Second, if transfers are to be neutral over the medium term as expected in those proposals it means an implicit assumption of a perfect regularity and symmetry of business cycles, which is far from the contemporary reality. Third, it underestimates difficulties with the ex ante identification of a given phase of the business cycle and the character of the shock (supply vs. demand, asymmetric vs. symmetric). Finally, it ignores the political economy and politics of any such redistribution mechanism which most likely will make transfers permanent rather than temporary and repayable.

If we go beyond the economic policy sphere we can find more cases of potential benefits coming from centralizing decision making and pooling fiscal resources at the European level. This may relate to, for example, defense and security policy (see Briani, 2013), the protection of external borders, common consular services, environmental policy and many others.

However, the economic rationale for the centralization of certain new functions will always have to be confronted with political considerations such as national sovereignty concerns (Begg, 2009), the interests of the incumbents at the national level[12] and a limited appetite for cross-border fiscal redistribution[13]. As a 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 (see Mortensen, 2004).

It is also worth noticing that not all currently existing common EU policies necessarily meet the test of optimal assignment of functions and resources as suggested by the theory of

[10] See the critique of Gros (2012), who argues that redistribution mechanisms in federal states such as the US may help decrease income disparities between regions rather than cushion asymmetric shocks. In his opinion, the US banking union seems to be the most effective instrument for addressing asymmetric shocks.

[11] Contrary to some popular views, current account imbalances between Eurozone countries cannot be considered sufficient evidence of idiosyncratic supply shocks.

[12] Examples include political reluctance to build European institutions of financial supervision or the trade unions' resistance to the creation of European air traffic control

[13] Buiter (2013) argues that a similar reluctance to cross-regional redistribution is observed within national states in Europe, resulting in secessionist tendencies in some of them.

fiscal federalism. This concerns, in first instance, the Common Agriculture Policy (CAP), which represents a clear case of overregulation leading to market distortions and resource mismanagement[14].

5. The size of the EU budget and its major components

In spite of some extreme opinions on the total absence of fiscal integration within the EU/EMU (e.g. Bordo, Markiewicz & Jonung, 2011 or Aizenman, 2013), there are already several components of genuine fiscal union in place, i.e., the EU budget, the newly created off-budget bailout facilities, the European Investment Bank (which plays several quasi-fiscal functions), the EU's own revenue sources, some harmonization of national indirect taxes, fiscal rules and their surveillance. Ironically, the quasi-fiscal operations of the ECB since May 2010 (see Dabrowski, 2012) also add to the complex picture of fiscal federalism in the Eurozone.

The size of the EU budget has oscillated around 1% of the EU's Gross National Income (GNI) for a long time and its own revenues are not allowed to exceed 1.23% of the EU's GNI.[15] Its expenditures must be closely matched by revenues. The EU is neither allowed to borrow nor accumulate budget surpluses (the latter must be returned to member states). However, in the Multiannual Financial Framework (MFF) for 2014-2020, there will be a possibility to move unspent money between budget lines to finance other underfunded commitments in a given fiscal year.

Some proposals of a countercyclical Eurozone budget include its capacity to borrow on the financial market (Wolff, 2012). However, to be accepted by financial markets as a credible borrower, the EU authorities would have been granted respective revenue collection powers (i.e., the right to introduce federal taxes – see Section 6) or obtain guarantees of national governments (debt mutualization – see Section 8).

The EU budget in its current structure is dominated by cross-country transfer programs such as the CAP, cohesion and structural funds, and foreign aid, plus the costs of functioning EU institutions. Financing European public goods such as research or environmental programs plays a secondary role (see Swidlicki, Kullmann & Persson, 2012 for a detailed analysis).

[14] See Bureau (2012) on CAP evolution and remaining challenges.
[15] See http://ec.europa.eu/budget/explained/budg_system/financing/fin_en.cfm#other

This is the result of a strong path dependence, i.e., the impact of past decisions which, in turn, resulted from the necessity to reach a compromise on some key integration steps. For example, the Cohesion Fund was a by-product of negotiations on the Maastricht Treaty in early 1990s, the price of convincing less economically advanced member states to back the idea of the EMU and address their concerns that fiscal discipline required by the Treaty changes could result in insufficient investment in public capital (see Mortensen, 2004; OECD, 2007). The adoption of the MMF requires a unanimous decision by all member states,[16] which additionally narrows the room for any radical changes in the budget size and its expenditure structure.

The dominance of cross-country transfers makes net donor countries additionally reluctant to increase the EU's budget size, which was clearly demonstrated during political negotiations on the MFF for 2014-2020. On the other hand, the net recipient countries, especially those from Southern and Central and Eastern Europe, are interested in continuing transfers on the previous or even increased levels. In some cases, net transfer inflows have approached 5% of their GDP (Heinen, 2011).

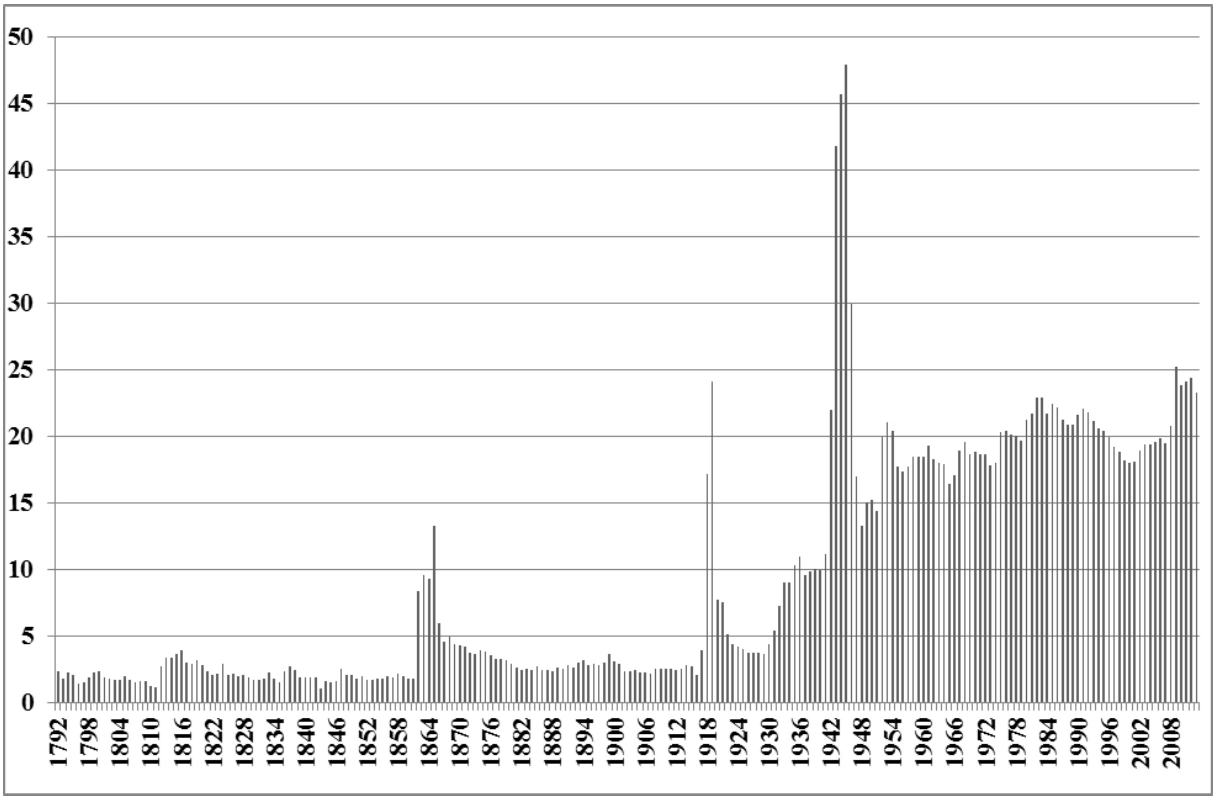
The above picture has changed with the creation of the European Financial Stability Facility (EFSF) in 2010, which was replaced by the European Stability Mechanism (ESM) in 2012, as a result of the sovereign debt crisis in several Eurozone countries. The ESM's lending capacity is EUR 500 billion, and the combined lending ceiling of EFSF/ESM is set at the level of EUR 700 billion (ESM, 2013), i.e., ca. 5 and 7% of Eurozone's annual GDP respectively.[17] The EFSF and ESM have substantially increased the fiscal power of the EU institutions in respect to EMU countries.

If one looks for historical comparison, in peace time, the US federal budget amounted to 2-3% of GDP until the beginning of the 20th century (Figure 1) and started to grow substantially only after the Great Depression in the 1930s. However, unlike the EU budget, it was concentrated on the provision of typical federal public goods such as general government services and national defense, with almost no redistribution and transfers.

[16] Formally the MFF is subject to co-decision procedure of the Council (representatives of all member states) and the European Parliament. Usually the European Parliament is in favor of a larger EU budget but the effective veto power of each individual member state in the Council makes its bargaining position weaker. The adoption of an annual EU budget is also subject to co-decision but requires only a qualified majority in the Council (instead of unanimity as in the case of MFF), which gives the European Parliament more room to influence the eventual decision.

[17] However, the maximum EFSF/ESM lending capacity cannot be mechanically compared with the size of EU regular budget because the former represents a one-off stock granted by the member countries and the latter – regular annual flow.

Figure 1: US total federal spending as a % of GDP, 1792-2013



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

6. The EU's budget revenue and tax policy

Although formally its 'own resources' form 99% of the revenue of the EU budget,[18] only the so-called 'traditional own resources' (i.e. 75% of customs duties on imports from outside the EU and sugar levies[19]) can be considered a sort of 'federal' taxation. The two other 'own resources', i.e. from value added tax (VAT) and the one based on GNI are calculated according to complicated country-specific formulas. 'Other revenue' includes taxes on salaries of EU staff, contributions from non-EU countries to certain programs, and fines, for example, on companies for breaching EU competition law. In addition, some net donor member states (the UK, Sweden, Netherlands, Germany, and Austria) enjoy various kinds of rebates.

[18] http://ec.europa.eu/budget/explained/budg_system/financing/fin_en.cfm#other
[19] The remaining 25% goes to national budgets to compensate for the cost of collection.

Summing up, most of the EU budget revenue comes from the financial contribution of member states, an amount that was individually negotiated in the process of adopting a MFF (which requires unanimity of all member states). Any substantial increase in the size of the EU budget in the future beyond the current range of 1% of GNI will probably require change in these proportions, i.e. developing direct revenue sources such as pan-European taxes. In turn, this will have to increase the role of the European Parliament (see Section 7).
At this stage of the debate on the EU/EMU fiscal federalism, it is difficult to predict which kind of 'federal' taxes may emerge in the future. Most likely, it may be new forms of indirect taxation on activities having a strong cross-border spillover such as a financial transaction tax or a carbon tax[20]. Interestingly, the proposals for using the Eurozone budget as an instrument of countercyclical fiscal policy and accommodating asymmetric shocks discussed in Section 4 (e.g., Wolff, 2012; European Commission, 2012) assume the fiscal contribution of member states rather than federal taxes.

Looking for historical comparison, the US federal government had very limited tax power (collection of import tariffs and part of excises – see Henning & Kessler, 2012) until the adoption of the 16th Constitutional Amendment in 1913 which created the legal opportunity to introduce federal income taxation.

The EU *acquis communautaire* also includes a certain degree of harmonization of national taxation. This relates to indirect taxes such as the VAT and excises and involves setting minimum and maximum rates, rules of adopting reduced rates and exemptions, principles of taxation in cross-border trade, etc. However, the purpose of these regulations is the elimination of the Single Market's internal barriers rather than the revenue considerations of the EU budget.

The same concerns the ongoing debate on the potential harmonization of direct taxation within the EU, especially corporate income tax (CIT) [21]. On the one hand, this is an attempt to eliminate cross-border obstacles for businesses and citizens and ensure an equal playing field across the Single European Market and get rid of 'unfair' or 'harmful' tax competition[22]. On the other hand, advocates of tax competition among various tax jurisdictions underline its role in supporting the competitiveness of the entire common market and putting a disciplining pressure on public finances at the national and subnational levels (see e.g., Issing, 2013).

[20] The debate on economic and social rationale of such taxation is beyond the agenda of this paper.
[21] See Zodrow (2003) for an overview of the earlier stage of this debate.
[22] See http://ec.europa.eu/taxation_customs/taxation/company_tax/harmful_tax_practices/index_en.htm

The existing federal states represent various degrees of harmonization of subnational tax rules – from high (as in Germany) to rather limited (as in the cases of the US and Canada) (Vaillancourt, 1992).

7. Institutional setup of the EU/EMU fiscal federalism

As discussed in Sections 5, 6 and 8, the EU/EMU 'federal' prerogatives are shared, in various proportions, among the European Parliament, Council and European Commission. Within the European Commission, individual commissionaires and directorates-general (DGs) deal with various aspects of EU fiscal federalism. This concerns, among others, DG for Budget (responsibility for EU budget), DG for Economic and Financial Affairs (surveillance of member states fiscal policies), DG for Taxation and Custom Union, and others.

Expanding the size of EU budget, moving more competences and policies to the European level, creating more European taxes, initiating new cross-country transfer programs, etc. would have to lead to the modification of the current power balance in favor of the European Parliament, at the cost of national legislatures and executives, and the Council which represents national governments. The role of the European Commission would also have to increase accordingly, however, under the democratic control of the European Parliament.

From this point of view, the new names of administrative bodies as suggested by some authors (e.g., Marzinotto, B., Sapir, A. & Wolff, G., 2011 who propose creating a Eurozone finance ministry) have a rather symbolic character. (Currently this role is performed by the DG for Economic and Financial Affairs). In some cases, these suggestions disregard the principles of collective responsibility of the European Commission and the proper balance between EU executive and legislative bodies.

8. Fiscal discipline vs. fiscal solidarity in times of distress

Fiscal discipline is very important for currency stability and, more broadly, financial and macroeconomic stability in any country/ territorial entity. However, it becomes critically important within federations, confederations and closely integrated economic blocks due to intensive cross-border spillovers and contagion, more opportunities to free ride at the cost of neighbors, and the moral hazard problem (expectation of bailout). Thus fiscal discipline should be considered an important common public good for the entire EU but even more importantly, within the EMU due to the obvious negative impact of fiscal imbalances on currency stability[23].

Fiscal discipline may be ensured by market mechanisms (danger of sovereign default) and formal fiscal rules (formal constraints), or a combination of both. In turn, fiscal rules can be divided into fiscal targets and fiscal procedures, which are either imposed by a federal center, self-imposed by a sub-federal entity, or negotiated by both (Eyraud and Gomez Sirera, 2013).

Table 1: General government net lending/borrowing, in % of GDP

Country	2007	2008	2009	2010	2011	2012
EU	-0.9	-2.4	-6.8	-6.5	-4.4	-4.1
Eurozone	-0.7	-2.1	-6.4	-6.2	-4.1	-3.6
Austria	-1.0	-1.0	-4.1	-4.5	-2.5	-2.5
Belgium	-0.1	-1.1	-5.6	-3.9	-3.9	-4.0
Bulgaria	3.3	2.9	-0.9	-3.9	-2.0	-0.5
Croatia	-2.1	-1.3	-4.2	-5.1	-5.2	-4.1
Cyprus	3.5	0.9	-6.1	-5.3	-6.3	-5.6
Czech Republic	-0.7	-2.2	-5.8	-4.8	-3.2	-5.0
Denmark	4.8	3.3	-2.8	-2.7	-2.0	-4.4
Estonia	2.8	-2.3	-2.1	0.4	1.7	-0.2
Finland	5.3	4.3	-2.7	-2.8	-0.9	-1.7
France	-2.8	-3.3	-7.6	-7.1	-5.2	-4.6
Germany	0.2	-0.1	-3.1	-4.2	-0.8	0.2
Greece	-6.8	-9.9	-15.6	-10.7	-9.4	-6.4
Hungary	-5.1	-3.7	-4.5	-4.5	4.3	-2.5
Ireland	0.1	-7.4	-13.9	-30.9	-13.4	-7.7
Italy	-1.6	-2.7	-5.4	-4.3	-3.7	-3.0
Latvia	0.6	-7.5	-7.8	-7.3	-3.2	0.1
Lithuania	-1.0	-3.3	-9.2	-7.1	-5.5	-3.0
Luxembourg	3.7	3.2	-0.8	-0.8	-0.3	-1.9
Malta	-2.3	-4.5	-3.8	-3.6	-2.7	-3.0
Netherlands	0.2	0.5	-5.6	-5.1	-4.5	-4.1
Poland	-1.9	-3.7	-7.4	-7.9	-5.0	-3.5
Portugal	-3.2	-3.7	-10.2	-9.8	-4.4	-4.9
Romania	-3.1	-4.8	-7.3	-6.4	-4.3	-2.5
Slovakia	-1.6	-2.0	-8.0	-7.7	-4.9	-4.9
Slovenia	0.3	-0.3	-5.5	-5.3	-5.6	-3.2
Spain	1.9	-4.5	-11.2	-9.7	-9.4	-10.3
Sweden	3.6	2.2	-1.0	-0.1	0.1	-0.4
UK	-2.9	-5.1	-11.4	-10.1	-7.9	-8.3

Note: yellow field indicates IMF estimate

Source: IMF World Economic Outlook database, April 2013

The EU/EMU mechanism of fiscal stability has been based on both market discipline and fiscal rules. The former was built around the 'no bail out' clause in Art. 125 of the Treaty of

[23] Interestingly, the high level of public indebtedness in the EMU (92.9% of GDP in 2012) and the danger of sovereign default in several EMU member states has not had a negative impact on Euro stability so far (see Dabrowski, 2012).

the Functioning of the European Union (TFEU) and the ban on debt monetization by the ECB (national central banks in the case of member states which have not yet introduced the Euro) - Article 123 of the TFEU. Fiscal rules have been imposed by Article 126 of the TFEU, the accompanying Protocol No. 12 and the EU's secondary legislation, i.e. the Stability and Growth Pact (SGP). They include numeric criteria on the maximum fiscal deficit and debt level (the so-called Maastricht criteria) backed by administrative and financial sanctions for breaching them, i.e., the Excessive Deficit Procedure (EDP).

This mechanism proved inefficient as demonstrated by high deficits and a rapidly growing public debt burden (Tables 1 and 2) and the danger of insolvency faced by several EMU member states (Greece, Ireland, Portugal, Spain, Italy, Cyprus, perhaps Slovenia) since 2010.

Table 2: General government gross public debt, in % of GDP

Country	2007	2008	2009	2010	2011	2012
EU	59.4	63.9	74.4	80.2	82.8	87.0
Eurozone	66.5	70.3	80.0	85.6	88.1	92.9
Austria	60.2	63.8	69.2	72.0	72.4	73.7
Belgium	84.0	89.2	95.7	95.5	97.8	99.6
Bulgaria	18.6	15.5	15.6	14.9	15.4	18.5
Croatia	32.9	29.3	35.8	42.6	47.2	56.3
Cyprus	58.8	48.9	58.5	61.3	71.1	86.2
Czech Republic	27.9	28.7	34.2	37.8	40.8	43.1
Denmark	27.5	33.4	40.7	42.7	46.4	50.1
Estonia	3.7	4.5	7.2	6.7	6.1	8.5
Finland	35.2	33.9	43.5	48.6	49.0	53.3
France	64.2	68.2	79.2	82.3	86.0	90.3
Germany	65.4	66.8	74.5	82.5	80.5	82.0
Greece	107.3	112.5	129.3	147.9	170.6	158.5
Hungary	67.0	73.0	79.8	81.8	81.4	79.0
Ireland	25.0	44.5	64.9	92.2	106.5	117.1
Italy	103.3	106.1	116.4	119.3	120.8	127.0
Latvia	7.8	17.2	32.9	39.7	37.5	36.4
Lithuania	16.8	15.5	29.3	37.9	38.5	39.6
Luxembourg	6.7	14.4	15.3	19.2	18.3	21.1
Malta	60.7	60.9	66.4	67.4	70.3	72.5
Netherlands	45.3	58.5	60.8	63.1	65.5	71.7
Poland	45.0	47.1	50.9	54.8	56.4	55.2
Portugal	68.3	71.6	83.1	93.2	108.0	123.0
Romania	12.7	13.6	23.8	31.1	34.2	37.0
Slovakia	29.4	27.9	35.6	41.0	43.3	52.3
Slovenia	23.1	22.0	35.0	38.6	46.9	52.6
Spain	36.3	40.2	53.9	61.3	69.1	84.1
Sweden	40.1	38.8	42.5	39.4	38.3	38.0
UK	43.7	52.2	68.1	79.4	85.4	90.3

Note: yellow field indicates IMF estimate

Source: IMF World Economic Outlook database, April 2013

Financial markets have never seemed to take the 'no bail out' clause seriously, as demonstrated by very low yield spreads prior to the 2008/2009 global financial crisis, in spite of big differences in the fiscal positions of individual countries[24]. And they proved right because this clause was *de facto* suspended with the adoption of the first financial assistance package to Greece and building a temporary (EFSF) and then permanent (ESM) bailout facility (see Section 5). Before the first rescue program for Greece, in 2008-2009, the EU provided the so-called balance-of-payment support to three non-EMU member states, Hungary, Latvia and Romania. Thus the 'no bail out' principle has been replaced by a policy of conditional bailout (financial assistance in exchange for a country's commitment to fiscal adjustments and necessary reforms).

Fiscal rules imposed by the TFEU and SGP also did not ensure sufficient fiscal discipline. They were frequently breached (sometimes by a large margin) and no financial sanctions were ever adopted. Even in the short one-year testing period prior to admission to the EMU, when each candidate country has to demonstrate its compliance with the Maastricht criteria, the rules only partially worked. Most EMU candidates missed either the debt or the deficit criterion, or both, but were nevertheless admitted. This was the case with Austria, Belgium, Cyprus, France, Greece, Ireland, Italy, Malta, Netherlands, Portugal and Spain.

Not surprisingly, after adopting the Euro, member states' incentives to follow the EU's fiscal rules became even weaker. As most of them breached the rules in the early 2000s, including the two biggest EMU members (France and Germany), no effective enforcement mechanism of the SGP could be expected. Furthermore, the coalition of 'bad boys' led to a substantial softening of GDP in 2005 by adding several exemptions which could justify non-compliance with the TFEU and SGP.

The same kind of coalition (and political economy mechanism behind it) seems to continue after the 2008/2009 global financial crisis, despite the serious reinforcement and strengthening of formal fiscal rules, especially within the EMU. The latter concerns both the 'preventive' and 'corrective' arms of the SGP (which now include automatic and meaningful sanctions) and other EU secondary legislation which obliges EU member states towards enhancing their national fiscal rules and institutions either through constitutional changes or

[24] There are also other possible interpretations of very low spreads such as ex ante expectations of fiscal consolidation in countries with higher deficits and debts based on rapidly decreasing borrowing costs, the potential impact of EU fiscal rules and the impact of a lax US monetary policy which has led to abundant global liquidity (see Dabrowski, 2012; Issing, 2009). However, these interpretations do not necessarily contradict the hypothesis on the low credibility of the 'no bail out' clause.

equivalent legislation. The new fiscal rules are backed by the new intergovernmental Treaty on Stability, Coordination and Governance in the Economic and Monetary Union.

Nevertheless, the effectiveness of the reformed fiscal rules in practice remains unclear. The SGP provisions continue to contain numerous exemptions and ambiguities related, in first instance, to the *ex-ante* estimation of potential output and other characteristics of the business cycle. In addition, most of the EU and EMU member states continue to be subject to the EDP,[25] which makes them reluctant to impose peer pressure on other 'brothers in trouble'. As a 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 adopted yet.

Summing up, the EU and EMU have moved definitively from a 'no bail out' principle to a conditional bail out policy with a parallel attempt to strengthen formal fiscal rules of disputable efficiency.

It is worrisome that the dominant tone of the debate on the Eurozone's fiscal union seems to go even further in this direction. The European Commission (2012) suggests the creation of a European Redemption Fund, an idea originally developed by the German Council of Economic Advisors, which means a step further towards a conditional bailout policy as compared to the current solutions. On the other hand, the European Commission (2012) would like to further increase its prerogatives to monitor national budgets, including some kind of veto power in respect to national budget decisions[26]. This would make EU fiscal rules increasingly intrusive and rather incompatible with the dominant political and legal architecture of the EU (a sort of limited federation or confederation)[27].

Some authors suggest even more, i.e., moving from conditional towards unconditional fiscal and monetary bailout policies. Their two main proposals are: debt mutualization and creation of a lender of last resort (LOLR) facility for governments.

Debt mutualization should be achieved by issuing Eurobonds, which would be jointly guaranteed by EMU members. The first time this proposal was analyzed publically soon after launching the Euro was in Giovannini et al. (2000) report. The main concern at that time was

[25] 15 member states in mid-2013. Between 2009 and 2012 this number frequently exceeded 20.

[26] Since 2011 the procedure of the European Semester has been in place, which is a kind of 'soft' coordination and monitoring mechanism of the economic and fiscal policies of EU member states (discussion of draft national budgets and accompanying economic policy assumptions).

[27] Referring to Eyraud & Gomez Sirera's (2013) classification of arrangements aimed at constraining fiscal policy's room for maneuver of sub-federal entities, this would mean moving from the fiscal rules imposed by the center (the current regime) to direct controls by the center.

the creation of an integrated and liquid financial market within the Eurozone. The idea came back at the end of 2000s and early 2010s, in the context of the global and European financial crisis, this time with a clear intention to help countries in trouble. Some of those proposals can still be considered a form of conditional bailout, e.g., the Blue Bond proposal of Delpla & von Weizsaecker (2010). Others represent either an unconditional bailout or a bailout with very weak conditionality (see e.g., Soros, 2012; De Grauwe, 2013).

The LOLR proposal calls for the unlimited and unconditional commitment of the ECB to purchase debt instruments issued by Eurozone governments in case of market distress (see e.g. Bofinger & Soros, 2011; Layard, 2012).

Both proposals have been justified on the grounds of arresting the irrational behavior of financial markets, avoiding cross-country contagion, and helping governments that are temporary illiquid but fundamentally solvent survive. Unfortunately, assumptions and intentions behind those proposals are often naïve (as they tend to overestimate the fiscal sustainability of some Eurozone countries), difficult to operationalize in practice (distinguishing illiquidity from insolvency[28]), and largely ignore the moral hazard problem. In addition, the idea of the LOLR to governments is deeply flawed and based on dubious theoretical foundations. It confuses, intentionally or unintentionally, the governments with commercial banks (Dabrowski, 2012).

Unfortunately this part of the debate on the EU/EMU fiscal federalism either ignores or wrongly interprets other countries' lessons, including those of the US. The US federal authorities have not bailed out any state since the 1840s and this has created one of the strongest incentives for states to adopt their own guarantees of fiscal discipline. Most US states have introduced various kinds of fiscal disciplining rules in their constitutions and secondary legislations but none of them has been imposed by the federal government. Similarly, counties and municipalities cannot expect a bailout from either the state or federal government. Thus the danger of default serves as the strongest incentive to put state and municipal finances in order (Bordo, Markiewicz & Jonung, 2011; Henning & Kessler, 2012). The similar 'no bail out' practice governs the Canadian federation (Bordo, Markiewicz & Jonung, 2011).

[28] Greece is an extreme case which received its first aid package in May 2010 on the assumption it was illiquid but solvent. Soon this assumption had to be revised, leading to sovereign debt restructuring in 2012.

On the other hand, those federal states which failed to ensure the fiscal discipline of their subnational governments and provided them with bailouts (such as the examples of Argentina and Brazil discussed in the analysis of Bordo, Markiewicz & Jonung, 2011) have suffered serious fiscal and monetary stability problems at the federal level.

Some advocates of Eurobonds (e.g. De Grauwe, 2013) refer to the early US experience in 1790, when the then-US Secretary of the Treasury, Alexander Hamilton, convinced Congress to pool state debt from the time of the Revolutionary War and assume federal responsibility for its redemption (matched by the assignment of import duties and part of excise taxes on alcohol to the federal budget), which led to building the foundation of fiscal federalism in the US. Yet this comparison is flawed as correctly pointed out by Gros (2010) because there is a large political difference between pooling responsibility for debt accrued during the common war on independence (the case of US) and the debt accumulated as a result of imprudent national fiscal policies and excessive welfare states in peace time (the case of the European debt crisis).

9. Conclusions

The European debt and financial crisis in the early 2010s triggered a debate on the lacking components of the EU and EMU integration architecture. The frequently expressed opinion is that the very existence of a CCA requires a more advanced stage of fiscal and political integration between their members. Consequently, the sustainability of the common currency depends on how quickly progress in this area can be accomplished.

However, an analysis of both historical and contemporary experiences with monetary unions, especially those initiated by sovereign states, gives a more nuanced picture. In some cases, integration has been limited to the adoption of a common currency/common monetary standard and has not been followed by fiscal and political integration. Despite this deficit, monetary union can work successfully for several decades. Also the OCA theory does not provide an unquestionable argument in favor of the necessity to complement monetary integration with the centralization of fiscal resources. Thus the question of how much fiscal and political integration is needed to save the Euro project requires further discussion based on a more fact-based comparative analysis and a less emotional approach.

On the other hand, the current integration architecture of the EU/ EMU already contains several elements of fiscal union, for example, the EU budget and off-budget bailout facilities, the EU's own revenue sources, harmonization of indirect taxes at the national level, substantial cross-country transfers, and fiscal rules and their surveillance. Furthermore, in several important policy areas such as financial supervision, defense, security, border protection, foreign policy, environmental protection, and climate change, the centralization of tasks and resources at the Union level could offer increasing returns to scale and a better chance of addressing pan-European externalities. These are not necessarily related to a common currency and, in most cases, the potential benefits of further integration will not be limited to the Eurozone but will cover the entire EU. Thus the debate on fiscal and political union cannot be limited to EMU members.

Ideally, reforming European fiscal federalism should involve all EU member states and should use the community method rather than concluding new intergovernmental agreements formally outside the EU (the latter leads to decreasing transparency and effectiveness of EU governance).

A functional analysis based on the theory of fiscal federalism can provide a useful tool in the exact specification of those policy areas, which are the best candidates for integration at the EU/EMU level. However, in each case, the economic rationale of potential centralization must be confronted with political constraints and the principle of subsidiarity, the basic constitutional rule governing the EU.

If additional tasks and mandates are to be moved to a supranational level, this would have to lead to a larger EU budget, exceeding the current level of ca. 1% of EU's GNI. If this happens, it will have an impact on revenue sources and the decision making process. More fiscal centralization will require the introduction of European taxes, and the increasing political power of the European Parliament, at the cost of individual member states, whose veto power in EU budget process will have to be reduced.

Harmonization of national taxation is a separate issue related to the Single European Market rules rather than EU budget and fiscal power of EU governing bodies. Here the attempt to create an equal playing field for business activity and eliminate cross-border barriers must be balanced against the rationale of tax and regulatory competition between member states.

However, regardless of how far the future process of fiscal integration within the EU and EMU will progress, it must be based on sound foundations of fiscal discipline at all government levels. As national budgets play and, most likely, will continue playing the most important role in the entire EU budget system, ensuring prudent national fiscal management seems to be the number one challenge, especially in the context of the sovereign debt crisis experienced by several member states.

Historical experience demonstrates that market discipline, i.e., the danger of sovereign default, supplemented by clear and consistently enforced fiscal rules, is the best solution to this problem. And this was the founding principle of the EMU at the time of the adoption of the Maastricht Treaty. Unfortunately, it was changed in 2010 when the 'no bail out' principle was replaced by conditional financial assistance to countries in fiscal troubles, accompanied by building a permanent bail out facility within the EMU. This was the result of giving in to financial market pressure and fear of sovereign default and the resulting financial contagion, including the potential disintegration of the Eurozone. The latter proved unjustified: the *de facto* default of Greece in the spring of 2012 did not result in its exit from the CCA[29].

The parallel effort to strengthen the fiscal rules imposed by the EU secondary legislation and the new intergovernmental Treaty on Stability, Coordination and Governance in the Economic and Monetary Union cannot compensate for a weakening market discipline, especially since national policymakers are not enthusiastic to internalize those rules in practice. As far as most member states, including the largest ones, experience problems with meeting the TFEU and SGP fiscal targets, the peer pressure mechanism assumed in the SGP and surveillance procedures (including the European Semester) will not work effectively.

Unfortunately, several proposals floated in the name of building 'genuine' economic and monetary union with a strong fiscal component (such as Eurobonds, LOLR or centralizing Eurozone funds and providing member countries with temporary fiscal transfers) could lead to weakening market discipline even further. And they could not be compensated by even more intrusive control of national budgets by the European Commission or other EU governing bodies as suggested in some proposals.

[29] Similarly, the default of Detroit in July 2013 did lead to exit of this city from the US dollar monetary area.

If implemented, such proposals will lead to building a dysfunctional fiscal union which encourages moral hazard behavior by both national authorities and financial markets. Economic history provides us with numerous examples of dysfunctional fiscal federalism, which resulted in deep fiscal imbalances on the federal level and currency instability. These are the lessons which must be taken very seriously in the debate on the future of European integration, especially its fiscal component.

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