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Fiscal federalism as a solution for the eurozone problems

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Recent economic problems have proved once again that the best trigger for European integration is crisis. As for now the causes of world financial crisis and European debt crisis are not the main subject of economists' polemics. The key problem is how to avoid or prevent euro zone from next asymmetric shocks and improve its shock absorption capabilities? European Union (EU) introduced one of the most complex reform packages in its history. Recent EU reforms solve many of current problems which led in some member countries of euro zone to debt crisis. But the key issue is whether they lead euro zone to next stages of economic integration that would help to prevent and cope with future crisis which surely will come. The theory of economic integration as one of the solutions suggests to go further than what was already created within European Union and particularly within eurozone – a political union (Lubbe, 2003). An integral part of this stage is fiscal federalism. In this paper I would like to highlight causes of recent economic crisis and explain why fiscal federalism would solve many of current problems. I will also introduce current propositions of UE reforms and try to assess whether they lead to fiscal federalism as the best way for efficient macroeconomic governance in the euro zone.

Keywords: Fiscal federalism, European Union, Economic Governance, Eurozone, EU Budget.

Federalizm fiskalny jako rozwiązanie problemów gospodarczych strefy euro

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Ostatnie problemy gospodarcze udowodniły raz jeszcze, że europejska integracja ma tendencję do przyspieszania w obliczu kryzysu. Przyczyny kryzysu finansowego, a następnie na rynku długu publicznego w strefie euro zostały kompleksowo zdiagnozowane. Wyzwaniem w tym zakresie pozostaje kwestia, w jaki sposób można wzmocnić odporność strefy euro przed następnymi szokami asymetrycznymi oraz jak zwiększyć zdolność do ich absorpcji. W odpowiedzi na te wyzwania Unia Europejska opracowała jeden z najbardziej kompleksowych pakietów reform w swej historii. Kluczowym pytaniem pozostaje czy prowadzą one do dalszej integracji ekonomicznej, która nie tylko zwiększyłaby odporność strefy euro na wahania koniunktury gospodarczej, lecz także możliwości absorpcji szoków. Teoria ekonomicznej integracji sugeruje, szczególnie dla strefy euro jako najbardziej zintegrowanej grupy krajów, utworzenie unii politycznej (Lubbe, 2003). Jej integralną częścią stały się zapewne federalizm fiskalny. W niniejszej pracy autor komentuje możliwe korzyści płynące z wprowadzenia federalizmu fiskalnego w Unii Europejskiej. Dokonana została również ocena ostatnich reform pod kątem ich zbieżności z modelem federalizmu fiskalnego jako rozwiązania mogącego się przyczynić do podniesienia efektywności polityki gospodarczej w strefie euro.

Słowa kluczowe: federalizm fiskalny, Unia Europejska, strefa euro, zarządzanie makroekonomiczne, budżet Unii Europejskiej.

JEL: F15, E60, E62

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1. Introduction

The recent crisis forced the European Union authorities to conduct one of the most complex reforms in its history. The problem which occurs is whether these reforms are well addressed and able to improve the European Union's performance in its weakest field – vulnerability to asymmetric shocks, which are the main threat for the common currency area. The author discusses this issue suggesting that implementing fiscal federalism should be taken into account as a comprehensive solution for reducing the eurozone's vulnerability to asymmetric shocks and improving its shock absorption capacities. However, there are several questions which should be answered. First – what are distinctive features of fiscal federalism? Second – how far is the European Union from the fiscal federalism model? Third – do the recent reforms bring the EU closer to the fiscal federalism model?

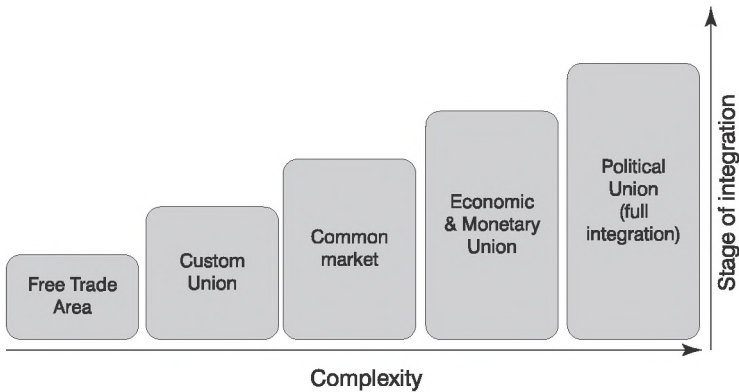
This paper applies a qualitative analysis based on a literature study related to such areas as the economic integration theory, the optimum currency area theory and economic governance. The main emphasis is placed on the fiscal federalism theory in the field of economics, which gave a background for description of general features of fiscal federalism. The result of this study is confronted with the advancement of European integration. Finally, special attention is devoted to the recent EU reforms, where the author gives some comments in the context of a possible EU fiscal federalism aspiration.

2. European integration – what is a missing puzzle?

Consequences of the financial crisis were much more severe for the European Union than for the United States. This is because it has turned into a sovereign debt crisis of some member states of the eurozone. Although there was no one main cause of the recession in the eurozone – they varied from country to country (Werning, Farhi, 2012), there is a possibility to aggregate some of them into bigger categories such as:

- Failures in the monetary policy area – e.g. lack of financial supervision and an institution of lender of last resort,
- Failures in the fiscal policy area – e.g. too expansive fiscal policy that affected competitiveness of certain economies,
- Failures in the economic governance area – lack of coordination of fiscal policies, which weakened common monetary policy.

This ineffectiveness contributed to macroeconomic imbalances and instability in the financial sector. Looking from even more general perspective, current problems are the consequence of incomplete stages of economic integration. As assumed in one of the most popular divisions of levels of economic integration (Lubbe, 2003), the process consists of 5 main stages, which are presented below in Graph 1.



Graph 1. Stages of economic development. Source: own study based on: A. Lubbe (2003). *Ekonomiczne podstawy integracji*. W: D. Milczarek and A.Z. Nowak (Eds.), *Integracja Europejska Wybrane Problemy*. (p. 237–267) Warszawa: Centrum Europejskie Uniwersytetu Warszawskiego.

Where is the European Union in the graph above? It has not finished building its common market yet. Although its construction began in 1951¹, a part of it is still fragmented and supervised by means of heterogeneous rules either because of political issues or creation of new areas of trade (for example there is still a lot to be done in the area of services, especially those provided via the Internet). In 1999, simultaneously with the-then quite advanced construction of the common market, the European Monetary Union (EMU) was introduced. In 2002, twelve national currencies were replaced by the euro. Similarly to the previous stage, this one has not been completed yet. But while the results of unfinished construction of the Single European Market just limited trade creation effects, the incomplete economic and monetary union brought about some serious failures in economic governance and increased the EU's vulnerability to shocks. Countries that join the EMU do not have tools which would mitigate the consequences of its biggest threat – asymmetric shocks. In this context, it may be beneficial to compare the eurozone to the United States of America. Members of the eurozone like states in the USA do not have their own currencies so, when facing a deep crisis, they cannot devalue or depreciate their currencies to improve competitiveness of their products and foster export. They do not have any direct influence on interest rates and neither do states in the USA. But unlike the European Union, the United States of America does have a central budget that has funds and built-in stabilization mechanisms that can help states or sectors of economy suffering from an economic crisis. In such circumstances, the euro was an exogenous currency which helped to maintain external, rather than internal, balance (Nowak, Ryć, 2014). The exogenous character of the currency and

inefficient institutional development – due to unfinished economic and monetary union stage – were mainly responsible for the consequences of this crisis, which were much more severe for the EU than for the USA (even though the USA has bigger public debt, so presumably is exposed to a higher risk of sovereign debt crisis).

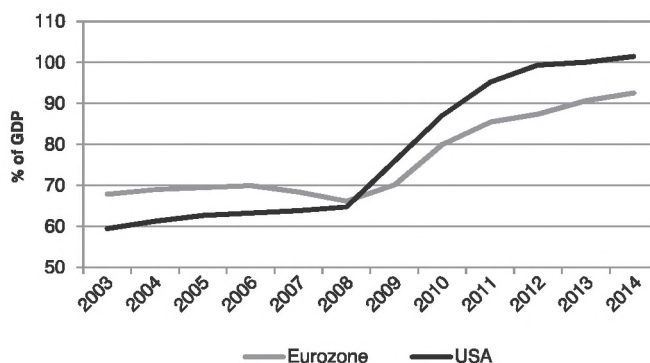


Chart 1. Public debt as a % of GDP. Source: <http://www.tradingeconomics.com>.

This suggests that the size of public debt within the eurozone should not be regarded as the main and only problem. A serious issue was the lack of instruments that could help regions hit by asymmetric shocks. As a result, countries with significant macroeconomic imbalances were practically left alone. This threat was predicted by many economists. De Grauwe (2011) noticed that this situation induced unfavorable market sentiments that forced them into default. Fatas looked at this issue from the point of view of the Optimum Currency Area theory (Fatas, 1998, p. 1). He pointed out that as prices and wages are not flexible enough to compensate for the loss of exchange rates and the degree of labor mobility in Europe is very limited, there is a fear that asymmetric shocks could lead to deep regional recessions and large increases in unemployment which could create a social burden that is politically unacceptable to many governments.

That is why Europe needs a complex solution which will have an influence on areas that are generating risks and help absorb future crises. One of possible solutions is a fiscal union based on fiscal federalism as a system which fits it best and helps to share risk among all of the members countries. This solidarity would be one the most effective tools of protection from disturbances generated by financial markets. Some of experts like de Grauwe (2012, p. 119) go even further suggesting that building a fiscal union is not enough – a political union is what the eurozone needs and would solve most of the current problems. However, he admits that it is hardly possible and rather smaller steps on the way to a political union are feasible.

3. Fiscal federalism

There is no one, coherent definition of fiscal federalism (FF). Starting with the most general one, fiscal federalism is a fiscal policy in a federation (Stiglitz, 2004, p. 879). This definition, despite generalization, is very important for the EU from one point of view – FF would require the European Union to make a significant change in its political system (centralization of fiscal policies), which is the main drawback in terms of possible implementation of this model within the European structures.

Among other definitions of FF, the one that is most synthetic, on the one hand, and that focuses on crucial features of the model, on the other, is probably the definition formulated by Oates (Oates, 1999, p. 1120). He pointed out that “[...]the subject matter of fiscal federalism is which functions and instruments are best centralized and which are best placed in the sphere of decentralized levels of government. As a subfield of public finance, fiscal federalism addresses the vertical structure of the public sector”. This definition comprises a built-in crucial assumption of fiscal federalism that provision of public services should be located at the lowest level of government. It means that FF can bring supply of public goods and services closer to Pareto optimality by centralizing those which are homogeneous, intended for all citizens, and decentralizing those which are specific to only some of the regions. As shown above, the European Union needs an economic union to build a stable system of economic governance. However, it is not obvious which policies should be centralized and to which extent they will be more efficient at the local (national) level. This is a political issue as well because the process of building fiscal federalism will be bottom-up so it will mean shifting national competences to the European level.

4. Features of fiscal federalism vs European Union

In the context of European integration, FF would be beneficial because of the basic feature of this model – it is designed for heterogeneous countries (e.g. economically, geographically, ethnically etc). Heterogeneity means different needs of local communities and that is why a unitary system, by providing homogeneous public goods and services, will be less efficient than fiscal federalism, which fits decentralized structures best. Another characteristic feature is the existence of at least two levels of government. They can be named in various ways: central vs local, federal vs state or supranational vs national. A distinctive feature of fiscal federalism is the division of economic roles between federal and states’ governments. The crucial role of local governments should be to supply local public goods and services while the central government should take care of the supply of national public goods and services (Stiglitz, 2004, p. 886). Furthermore, the central budget may have a deficit because it is responsible for macroeco-

conomic stabilization while budgets of local governments should be balanced. This is a configuration system that is exactly opposite to the European one. In fiscal federalism, the federal government has also a decisive impact on local powers that are responsible for provision of local public goods mainly through Pigouvian system of taxes and subsidies. They are necessary as the activity of one local government can affect others. In literature on FF, this kind of impact is called externality. It can be either positive or negative. The main task of subsidies (i.e. matching grants) is to influence possible positive externalities. "Recipient governments, in the pursuit of local welfare maximization, would then extend the outputs of such local public goods to the point where marginal social benefits for society as a whole equal marginal cost" (Oates, 2005, p. 351). The main purpose of taxes in this context is to reduce the negative externalities (i.e. air pollution). In general, the objective of the system of taxes and subsidies in fiscal federalism is to internalize federal governments' goals by local ones. In the European Union, for example, the advantage of FF would be developing, either by subsidies or by taxes, such national economic policies that would positively affect European economy as a whole and reduce its vulnerability to shocks.

The case of taxation may be analyzed in fiscal federalism from different points of view. Oates (Oates, 1999) indicated that an important role in the division of power within fiscal federalism is played by proper assignment of taxation powers. According to his research, the most beneficial situation is such where non-benefit taxes are under the federal government's control and benefit taxes are controlled by local governments. This is because local governments should be responsible for creating optimum conditions for households (e.g. public transport, hospitals, theatres) and business (e.g. education, infrastructure) while the central government needs higher revenues (non-benefit taxes are usually the biggest source of budget revenue) for providing national public goods such as defense policy or financing subsidies to foster positive externalities across the country. This point of view is close to the Tiebout model, which introduced the local governments competition perspective (Tiebout, 1965, p. 417). It assumed that local governments wanting to attract the best tax payers (households and enterprises) would compete by providing an optimal level of supply of local public goods and services in terms of the level of taxation. Although the Tiebout model played a significant role in the theory of economy of the public sector, its popularity was not just the case of acceptance of the model but also of questioning some of its assumptions and conclusions.

National competition, similar to the Tiebout model, as a way for improvement of whole European competitiveness is also in line with the Commission policy and economic recommendations for member countries. The problem is whether it has sufficient funds and structure of revenues for internalization European goals by national governments in a way fiscal federalism suggests.

The European Union's budget has 4 main sources of revenues:

- Traditional own resources (customs duties and sugar levies),
- Gross National Income (GNI) - based own resources,
- VAT own resources,
- Other revenues and surplus from the previous year.

Along with increasing globalization and reduction of customs duties, the share of traditional own resources in the European central budget decreases. They account for approx. 12% of budget revenues. In close future, if the European Union creates a free trade area with the USA, the revenues from customs duties and sugar levies may even be smaller. VAT own resources correspond to the theory of fiscal federalism the most. The only problem is the level of the tax rate. The European Union collects only 0.3% of total VAT revenues; furthermore, there are exceptions to this rule and some of the countries contribute only from 0.1% to 0.225%. Generally, VAT own resources account for only 11% of total revenues. GNI-based resources are currently the biggest source of revenue for the European central budget (76% of total revenues). They cannot be regarded as a typical own source of the budget as European institutions do not have any direct influence on that amount. Any changes in GNI-based resources would have to be a subject of negotiations among the member states, which would not be a simple task. The fourth source are taxes paid by EU institutions employees on their salaries, contributions from non-EU countries to certain EU programs and fines on companies that breach competition or other laws. These miscellaneous resources add up to around 1% of the budget (see: European Commission, 2014a) and cannot be perceived as a promising and significant source of revenues.

The shrinking source of traditional own resources, complicated and long process of bargaining (considering e.g. the expenditure-side of budget) create a need for new resources. Nowadays, there are two ideas of a central budget revenue reform. The first one is to raise the ratio of VAT own resources from standard 0.3% to 1%. One of the biggest problems of this idea is that in times of crisis hardly any member state would be eager to resign from revenues to its own budget in favor of the European one. As at 20 June 2014, 11 out of 28 member states were under the *Excessive Deficit Procedure* (EDP), which means that their budget deficits exceeded 3% of GDP and were far from the *Medium-Term Objectives* (MTO). Considering that during the 12-month period of 2010-2011 there were 24 member states under the EDP, it may be perceived as a significant improvement (Council of the EU, 2014) but still giving up VAT revenues in favor of the central budget is a problematic issue. The second idea of reforming the EU budget revenue side is to implement a common system of *Financial Transaction Tax* (FTT)². Its main objective was to replace old sources by a new, more effective one, with a possibility for increasing future EU budget. A significant role of this tax was to reduce excessive speculations on financial markets,

so it was intended to work as a Tobin tax. This solution is as problematic as the first one because of high disproportions in the share of turnover on financial markets among member countries. In case of a single tax rate for all countries, which is rather unlikely to happen, the United Kingdom would pay the most. This is why Great Britain is the strongest opponent of FTT. Concerning fiscal federalism, each solution: a higher VAT rate contributed to the central budget and a financial transaction tax is in line with the assumptions that the federal budget should be financed by non-benefit taxes.

Regions of a federation have a high degree of autonomy in various policy areas but, facing an asymmetric shock, they cannot use exchange rate mechanism as an absorbing mechanism. According to Ardy (2004, p.84) "one process that mitigates the impact of asymmetric shocks on regions in nation states is a system of automatic transfers from the central/federal budget". These transfers have to cover 3 main functions to secure macro-economic stability of integrated states:

- intertemporal stabilization,
- interregional insurance,
- interregional redistribution.

The main objective of first two is stabilizing regional income while the third of them is used for reduction of inequalities in income among states (Fatas, 1998). Intertemporal stabilization allows a country to run a deficit during a crisis and pay it back when its economy is recovering. Such an action smoothes business cycle by reducing the scale of economic slow-downs and positively affects various variables, e.g. unemployment rate or household consumption. As the European Union central budget has to be balanced (TFEU, art. 310), it is not possible for it to perform the function of intertemporal stabilization. This is one of the reasons why especially the eurozone is exposed to severe crises. Its member countries cannot use the exchange rate mechanism as a shock absorption mechanism. No assistance will come from the EU budget as it has limited capabilities of transfers increase. The only hope is in local budgets but they are restricted by the EU regulation of 3% deficit and the EDP so their shock absorption effectiveness is also limited. The second function which a federal budget has to cover is interregional insurance. It is based mainly on the functioning of automatic stabilizers whereby regions with higher GDP growth contribute more to the central budget (because tax revenues are positively correlated with economic growth) than those which suffer from asymmetric shocks and have lower tax revenues. The EU budget does perform this function but only to a modest degree. Member countries' contributions to the central budget are not lump sums but percentage quotas calculated on the basis of variables described above in the section dedicated to the budget revenue sources. This means that contributions to the central budget made by countries that have higher GNI growth (and consumption, which positively

affects VAT revenues) are bigger than the contributions of those which suffer from an economic slowdown, have lower GNI growth and thus lower VAT revenues. The problem is that transfers from the European budget for different countries may have a limited impact on GDP growth – the difference between payments to the central budget and received transfers may not be enough to absorb the consequences of asymmetric shocks. Some of the member states are net contributors and it is hardly possible that the transfers from the central budget during an economic slowdown would have a significant impact on their economies.

The European central budget also performs the redistribution function. It collects money from the member states and transfers it to poorer regions via the cohesion policy. Almost 82% of all expenditure made through structural funds is allocated in regions (NUTS 2³) whose GDP per capita does not exceed 75% of the average of this indicator for all 28 member countries. There are many positive examples of influence of cohesion funds on reduction of GDP per capita disparities. However, there are cases where member states which are beneficiaries of the cohesion fund do not improve their competitiveness and their GDP per capita remains stable in relation to the average for all EU countries (e.g. Portugal or Hungary).

To cover the 3 types of functions described above, there must be a significant central budget in terms of size. However, since the literature does not clarify what is a sufficient relation of the size of the federal budget to GDP, it might be easier to describe its minimum size. The evidence from practice shows that there are significant differences between the size of the central budget in federal states. This is also a proof that fiscal federalism is a very flexible system. It allows for an easy adjustment to different economic and social systems as well as various cultures and geographical ranges of countries.

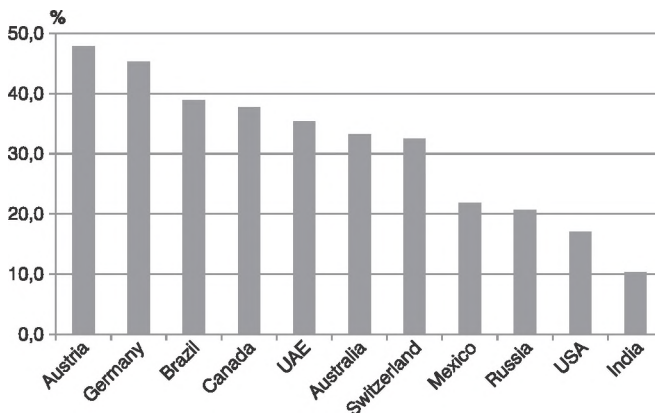


Chart 2. Taxes and other revenues to GDP ratio. Source: CIA World Factbook.

An analysis of several federal countries suggests that the size of the central budget should be at least 10–15% of GDP with an average of about 25–30%. Although the countries presented in the chart above are federations, the size of their federal budgets differs significantly. The biggest budget in terms of GDP is that of Austria (47.9%) while the scarcest one is that of India (10.3%). The size of the budget may depend on such factors as:

- division of power and responsibilities (some countries are more centralized, some more decentralized),
- the level and quality of supply of public goods,
- configuration of the economic system (e.g. European social model),

Several calculations were made for the European Union purposes trying to describe the proper size of the central budget⁴. Usually, the optimum size was estimated at around 20–25% of GDP. Realizing that building a federation within the European Union would be a complex process, estimations were divided into particular stages leading to a full federation. For the prefederation stage, the central budget should be at least 2–2.5% of GDP and for an early federation stage, around 5–7% of GDP. Nowadays, the EU central budget amounts to 1% of GDP, which is far from the calculations made even for the prefederation stage. Moreover, there is a pressure to reduce it even further.

Feature	Fiscal Federalism	European Union
Multilevel system of governments	Exist	Exist
Size of central budget	At least 5–7% of GDP (optimum 20%–25%)	≈ 1% of GDP
Budget characteristic	Central: possible deficit Local: balanced	Central: balanced Local: possible deficits
Redistribution mechanism	Exist	Exist
Budget functions	Central: redistribution, intertemporal stabilization, interregional insurance Local: allocative	Central: redistribution, interregional insurance Local: intertemporal stabilization allocative
Taxation	Central gov.: non benefit taxes Local gov.: benefit taxes	Central gov.: 0,3% of VAT Local gov.: all types of taxes

Table 1. European Union vs Fiscal Federalism before the crisis. Source: own study.

Summing up, the federal budget should be responsible for intertemporal stabilization, interregional insurance and redistribution while local governments, as they know the preferences of local communities better, should cover the allocative function. In the EU, the domain of the central budget comprises interregional insurance and redistribution while local governments are responsible for intertemporal stabilization and the allocative function. That is why, in terms of the FF theory, this is not an optimum assignment

of competences. The limited size of the EU budget and the fact that it has to be balanced imply that it cannot be considered as a stabilization tool for the EMU. As Ardy noted (2004, p. 88): “Although the structural policies do involve redistribution between members states, they cannot provide effective interregional insurance. This is because the budgetary expenditures are a subject to long bidding process with long time lags.” What is more – these expenditures are spent regardless of the regional economic situation, i.e. whether a certain region develops fast or not. Due to their relatively small size and all the ineffectiveness mentioned above, it should be considered that their macroeconomic impact is limited.

5. Comment on recent reforms

The recent crisis, except negative economic consequences, also gave a new incentive for further integration and reforms of the EU institutions. The most significant improvements in the area of economic governance and fiscal policy within the EU were achieved through the Economic Governance Package (commonly known as the six-pack) and the two-pack⁵. Intergovernmental agreements such as the Fiscal Compact or the Euro Plus Pact were also concluded and may be transformed into EU law in the future. In the monetary area, the European Stability Mechanism (ESM) may have the biggest influence on economic governance.

The aim of the **six-pack** is better coordination of economic governance within the European Union and the EMU in particular. To achieve this goal, it puts much more stress on debt reduction (reinforcement of the Stability and Growth Pact – SGP) and establishes a stronger framework for economic governance cohesion. The implementation of policy coordination should be ensured by the European Semester (a procedure of fiscal and structural reform monitoring within the EU⁶) and by the Macroeconomic Imbalance Procedure (MIP). Thanks to improvements made in national policies, the EU and especially the eurozone economy would be less vulnerable to its main threat – asymmetric shocks. Even though the potential economic impact of the six-pack is important, from the FF theory point of view there is also a significant change. According to Grosse (Grosse, 2013), it may be the beginning of transition of roles and especially a division of powers between national governments and the EU institutions. This shift is very important because it concerns a very important area of competence – budget policy. The European Semester introduced a procedure which requires national governments to submit national draft budgets to the European Commission for approval. That is why member countries are not fully independent in setting up their own budgets. This dependency has been even greater since 30th March 2013, when the **two-pack** came into the force. The general aim of these two regulations is to make national budgetary procedures surveillance even tighter and more transparent. That

is why they set common budgetary rules and a common budgetary timeline to be implemented by all member states.

Unlike the six-pack or two-pack, the **Euro Plus Pact** is not in fact a part of the European Union's law. It is an intergovernmental agreement signed by the eurozone countries and Bulgaria, Denmark, Lithuania, Poland and Romania, with an option to become a part of the European Union's law in the future. It assumes that countries-signatories of the agreement will endeavor to conduct internal reforms in order to increase their competitiveness, ensure macroeconomic stability through stable public finances and financial system, stimulate employment, and so on. Each country will undertake reforms in the above-mentioned fields, defining their scope annually. For each country-signatory, a set of indicators will be developed to allow for efficient measurement of the achievement of established targets. This should bring stabilization and convergence within the EU economy. From FF point of view, it is important that so many countries are willing to strengthen cooperation in the field of economic governance even if it is not a part of the European law. However, it would be better if all EU countries became signatories. It is important that, as it was stressed, direct taxes will remain the domain of member countries. It says nothing about indirect taxes but a possible interpretation is that indirect taxes will depend on the decisions made at the central level to a greater extent in the future, which is generally in line with the fiscal federalism theory. The Pact also assumes that countries will conduct reforms (often in very problematic areas such as public finances in general or e.g. pension system in particular) but it does not provide any incentives to motivate them to do so, which may weaken enthusiasm of the signatories to undertake necessary reforms.

Another intergovernmental agreement is the **Fiscal Compact** – a fiscal part of the document officially called *The Treaty on Stability, Coordination and Governance (TSCG)*. It was signed by all EU member countries except Great Britain and the Czech Republic. Its main objective is to strengthen the provisions of the SGP and the six-pack. It does so by placing emphasis on ensuring convergence towards the country-specific medium-term objective, as defined in the SGP, with a lower limit of a structural deficit (cyclical effects and one-off measures are not taken into account) of 0.5% of GDP (1.0% of GDP for member states with a debt ratio significantly below 60% of GDP). Correction mechanisms should ensure an automatic action to be undertaken in case of a deviation from the MTO or an adjustment path towards it, with escape clauses for exceptional circumstances (see more: European Commission, 2014b). For better enforcement of the Fiscal Compact provisions, it also provides sanctions for members (0.1% of GDP) if a country does not properly implement the new budget rules in national law and fails to comply with a Court of Justice ruling that requires it to do so. Regulations of the Fiscal Compact do not directly refer to any of fiscal federalism conditions. Similarly to the six-pack, it

concerns the budgetary procedure, which can be interpreted as a shift of power towards European institutions. However, not all countries have signed the Pact so its power may be limited from that point of view. Provisions of the Fiscal Compact may gain in importance because the Commission supports the objective to incorporate key provisions of the TSCG in the EU law as soon as possible – “the TSCG mentions a 5-year horizon, but some provisions may be enshrined in secondary legislation without delay” (European Commission, 2014b).

The **European Stability Mechanism (ESM)** is a permanent crisis resolution financial mechanism for the eurozone member countries. It issues debt instruments in order to finance loans and other forms of financial assistance to countries of the eurozone (ESM, 2014a). Although it is an intergovernmental organization under public international law, access to the ESM is ensured only for members of the eurozone which have ratified the TSCG. That is why it may be considered as the highest level of economic integration within the European Union so far. The ESM plays a significant role in recent EU reforms and in the context of fiscal federalism implementation as well. It is important because it equips the EU solutions (only for the eurozone members) with a mechanism that will complement it with the function of intertemporal stabilization, which was not provided by the central budget before the crisis. However, it works slightly differently from the intertemporal stabilization mechanism presented in fiscal federalism literature. In theory, facing economic slowdown, the federal budget can issue some debt to finance a stimulus program and pay back money during recovery. The ESM raises funds by issuing money market instruments as well as medium and long-term debt with maturities of up to 30 years (ESM, 2014b). These funds are backed up by money collected from its shareholders (€ 80 billion as paid-in capital from members of the eurozone) and an additional option for callable capital of approximately € 622 billion. This gives a sum of nearly € 702 billion, which allows for an effective lending capacity of € 500 billion. Compared to the size of the eurozone economy, it seems to be a modest figure, given in particular that a well integrated financial market can easily spread a crisis in one country to other member states. What is more, a country requesting financial assistance from the ESM should also send a similar request to the IMF. A beneficiary should undertake several initiatives such as public finance consolidation or structural reforms which should increase the competitiveness of its economy, so the assistance provided by the ESM is not automatic as in the federal budget. Although the ESM covers the function of intertemporal stabilization, it does not work as a typical budget in which money, if not needed, can be spent on different economic goals or used to repay the liabilities resulting from previous stimulus actions (reduce public debt to increase the capacity of future shock absorption). Its architecture is much more similar to the construction of the IMF and that is why its impact on current economy is weaker.

Summing up, recent reforms have the following impact on formation of fiscal federalism in the European Union.

Area of FF	Impact of reforms
Increase of size of EU budget	No
Growing importance of the function of the budget (e.i. interregional insurance)	No
Building-in intertemporal stabilization function	YES – through ESM
Centralization of fiscal policy	YES – to some extent by centralization of some aspects of budgetary procedures
Centralization of economic governance	YES – by better coordination of structural policies through sixpack (European Semester + MIP)

Table 2. EU reforms vs fiscal federalism. Source: own study.

6. Conclusions

The consequences of the crisis have usually been perceived as destructive. In economic terms, for example, they refer to an economic slowdown or recession, increase in unemployment rate and worsening living standards. Paradoxically, it was a very fruitful and constructive time for the European integration. Normally, institutional changes take a lot of time in the European Union. This happens for many reasons, i.e. divergent interests of members countries, a specific compromise building process and subsequent ratification of its results. The European Union has created the monetary union in 1999 and implemented the euro as its official currency in 2002. Probably, hardly no one expected that nearly ten years after such a significant step in the European integration the most complex package of reforms in the EU's history ever would be introduced. In this area – the development of European institutions – the crisis was a constructive trigger for further improvement of the monetary union that created foundations for the economic union.

Although some indicators have improved in recent years: the European economy is getting back on a growth path, the number of member states under the EDP is decreasing, it is still unclear whether it is just a natural process of recovery from a very severe crisis or an effect of recent reforms. What is also unsure is whether the EU, thanks to conducted reforms, has reduced its vulnerability to asymmetric shocks, which is one of the crucial problems the EMU has to face.

Despite the complexity of the reform package, the main underdeveloped European structures have not been fixed. As mentioned by de Grauwe (2011), EU leaders adopted a strategy of small steps. The problem is whether

these steps are not too small (are sufficient) and whether all these steps are leading to one coherent solution which will make the eurozone more shock resistant. Nothing was done for the enlargement of the EU budget as a way of providing stabilization functions. The European budget in terms of GDP remains very small compared to federal states. This implies that all stabilization functions of transfers, even if covered by the EU budget, have a relatively small impact. That is why its role in absorbing shocks remains very modest. An unsolved issue is the reform of sources of the EU budget that could introduce some automatic stabilizers or incentives to encourage the EU countries to follow the SGP rules. This unfixed issues may cause or strengthen consequences of the next crisis which, according to the theory of business cycle, will surely come sooner or later.

Before the crisis, the European Union already shared a lot of characteristics typical of fiscal federalism. However, one of its biggest problems was the lack of efficiency in implemented solutions. This is mainly because of insufficient amount of money collected and redistributed by the central budget. Nevertheless, fiscal federalism as a solution for the eurozone problems seems to be a real alternative to the EU reforms. On the other hand, recent regulations which require balancing local budgets or partial centralization of budgetary procedures are in line with basic properties of fiscal federalism. This may be considered as a preparation stage for partial communitarisation of public debts, issuing common bonds and enlargement of the central budget in the future, which would bring European solutions very close to the fiscal federalism model.

Notes

- ¹ See: Treaty of Paris Title 1 Art. 2; another document that can be perceived as a trigger for creation of a single European market is the Treaty of Rome (1957) Part 1 Art. 2.
- ² See more: FTT Directive, http://ec.europa.eu/taxation_customs/taxation/other_taxes/financial_sector/index_en.htm , 4.07.2014.
- ³ Mainly for Eurostat and EU regional policies purposes, a system was introduced for dividing up the economic territory into the EU NUTS (Nomenclature of territorial units for statistics), where NUTS 0 are countries and e.g. NUTS2 are main units of territorial division (such as Lands, Voivodships etc.).
- ⁴ See Werner Report: http://ec.europa.eu/archives/emu_history/documentation/chapter5/19701008en72realisationbystage.pdf 4.07.2014 or McDougall Report: http://ec.europa.eu/archives/emu_history/documentation/chapter8/19770401en73macdougallrepvol1.pdf 4.07.2014.
- ⁵ Two-pack – two legislative acts whose general aim is to strengthen the eurozone budgetary surveillance.
- ⁶ For a more detailed scheme of the European Semester see: <http://www.consilium.europa.eu/special-reports/european-semester?lang=en> 4.07.2014.

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