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A Fiscal Federalist Perspective of the European Political Economy

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Abstract

The present essay focuses on the financial aspects of the European federalist structure as a result of the Maastricht Treaty and its accompaniments. The European Union (EU) was an initiative for European integration on three integral aspects, namely, the three pillars which managed EU's legislature on economic, military, foreign, judicial, social, and environmental policies. The integration also laid down the "convergence criteria" to institute Euro as a common European currency in 2002. The Treaty on the Functioning of the European Union (TFEU) – the second of the two foundational treaties of the EU – discusses trade, domestic market, customs, taxation, and monetary policies along with other institutional and financial provisions for the member states of the Union. These two treaties form the legislative basis of European federalism. Drawing from the examples of both the Greek Debt Crisis and the Global Financial Crisis, it is opined that the European Union is better adept at managing crises that affect the entire world, rather than specifically its regions. Given the rise in secessionist movements as well as an increased resentment in the donor countries, the future of the Union post the pandemic-induced depression remains to be seen.

Keywords: Fiscal, federalism, European Union, Economy

1.0 Introduction

The Treaty on European Union, less formally known as the Maastricht Treaty, was signed on February, 7th 1992, establishing the new institutional order in the continent. The European Union (EU) was an initiative for European integration on three integral aspects, namely, the three pillars which managed the EU's legislature on economic, military, foreign, judicial, social, and environmental policies. The integration also laid down the "convergence criteria" to institute Euro as a common European currency in 2002. The Treaty on the Functioning of the European Union (TFEU) – the second of the two foundational treaties of the EU – discusses trade, domestic market, customs, taxation, and monetary policies along with other institutional and financial provisions for the member states of the Union. These two treaties form the legislative basis of European federalism. The present study focuses on the financial aspects of the European federalist structure.

2.0 Discourse on Fiscal Federalism

A federalist structure by its definition involves a decentralized system of governance, taxation, and public expenditure. The Decentralisation Theorem by Oates (1972) enumerates three features of a fiscally federalist structure. It states that the redistributive and the macroeconomic stabilisation functions of the state ought to be under the jurisdiction of the Central governing authority (CG). This is to ensure maximum efficiency by utilising the economies of scale at hand as well as accounting for the mobility of persons within the sub-central governments (SCG). The only function that ought to be in the SCG's jurisdiction as per Oates, is the allocative function that should be distributed geographically (Ward & Ward, 2009). It gains more significance especially in the European context, since having been relinquished of their monetary authority, the member states have control only over their fiscal policy.

2.1: Benefit Rule or the Principle of Financial Equivalence

This is in line with the Benefit Rule or the Principle of Financial Equivalence which states that the lowest level of government takes charge of the allocation of resources for a given region and the residents of the region – the benefactors of the public expenditure – should pay taxes for the same (Turok, 2006). As simple as it may sound prima facie, the argument has its shortcomings, the major one of the same being the "tax assignment problem". Sometimes, due to a mobile tax base or an allocative inefficiency of resources, the Benefit Rule does not stand. From a larger perspective, the differences in the allocation of resources at the same level of government in different geographical areas can violate horizontal equity as households in a poor jurisdiction would be suboptimally allocated than the richer ones (Ward & Ward, 2009). Hence, it is important to assign specific responsibilities for public expenditure at the respective levels of government which can be financed by well-defined measures of intergovernmental transfers as per their ability to borrow. However, to maintain horizontal equity unconditional grants are also permissible.

2.3 Working of Central Governing Authority and Sub-Central Governments

While the CG acts as an insurance or 'lender of the last resort' for the SCGs, there are contrasting opinions on the limits of the CG's power. The Centre prevents the SCGs from falling into the time-inconsistency trap of policymaking and inspires regional economic growth. However, it also oftentimes, implies looser budget constraints and procurement methods for the CG. The phenomenon of the CG wielding greater power to raise and utilise its income than the SCG, in turn, becoming a 'Leviathan', is termed as a vertical imbalance or fiscal mismatch (Turok, 2006). Moreover, in the absence of a hard budget constraint for the SCG, there is a possibility of moral hazard since little accountability can be expected from unconditional grants. The new fiscal federalism view stresses the budget constraint aspect of federalism, which would prove to be essential in the understanding of the policies of the EU in the Greek debt crisis. Parikh & Weingast (1997) emphasise the rights and limitations of each level of the government in a federalist structure. Each regional government ought to have primary authority over the allocative function of the region and they are (externally) institutionally bound by a strict budget constraint.

3.0 Fiscal Federalism in European Union

Of the two main kinds of federal systems– competition and coordination– the EU prefers the latter in its fiscal space. Also called democratic federalism, it seeks to balance out the potential gains or externalities against the inefficiencies in other regions by a centrally mandated policy (Inman and Rubinfeld, 1992). It can be seen as a latent threat to a federalist structure as well, owing to the Centre's increased power in goal-setting for centralised policymaking for the member states. The Treaty of Lisbon (2009) was implemented "with a view of enhancing the efficiency and democratic legitimacy of the Union and to improving the coherence of its action". However, the counterarguments to this treaty have been on the grounds of weakening the democratic framework of the union by introducing the qualified majority voting mechanism, contrasting unanimity voting which gave equal power to each national electorate in the Council of Ministers.

A coordinative structure also constrains the fiscal powers of the member states, albeit it is conducted voluntarily. Collignon (2003) itemises the two basic principles for cooperation in collective good supply in the EU:

1. If the benefits for one government are less than the total cost of providing the European good, there is a rational incentive to this government not to participate in the EU's provision of the collective good and to 'free ride.
2. The larger the number of the EU member-states, the less likely they are in providing the collective goods.

As a consequence, member states cannot have freely variable taxation systems either. Moreover, the budget balances for each state are determined by the Maastricht conditions of the Stability and Growth Pact (SGP), and owing to their interdependence, any expansionary effects of the same can be transferred to other member states (Ward & Ward, 2009).

An additional feature in the European federal structure is the full factor mobility within the member states (Bureau & Champsaur, 1992). It brings us back to the aforementioned argument of the efficiency of the redistributive and allocative policies can be increased by transferring the responsibility of the same to the CG instead. While it dilutes the federal structure of the union, it guarantees lower inequality and regional disparities, which also strengthen the solidarity within the union.

However, many proponents of the coordinative fiscal federalist view opine that lower fiscal competition paves way for states to collude on the decision of taxation policy, maintaining their tax revenue. Alternatively, it can act as a multilateral surveillance mechanism for the budgetary decisions of member nations without compromising their sovereignty.

4.0 The Greek Crisis

However, there is little empirical evidence that points towards the same. As with the case of the Greek debt crisis, both domestic and external authorities paid little heed to its vulnerable fiscal position. Despite the early warnings from the International Monetary Fund's (IMF), 2009 country report probed into its worrisome SGP indicators and a comparatively high debt-GDP ratio of 124.9%, there was little uproar in the Greek parliament over this for its political reasons (Fernandes, 2018; Zahariadis, 2013). Due to this, the fiscal crisis went largely unnoticed in the EU as well, till it ballooned up too much to be ignored. Zahariadis (2013) advocates clear market signals as a crucial measure in showcasing the state's accurate financials to the other members, ensuring accountability and transparency in the federation. This valuation ought to be reflective of the state's sustainability, especially in terms of its external and domestic debt on a mark-to-market basis, ensuring market discipline. Thus it acts as an indicator of the government's competence, in turn predicting and insulating the state from systemic shocks (usually arising from unverifiable policies).

While a preferable corrective or even punitive action could have been the exercise of the 'no bailout' clause, the cost of not bailing Greece out outweighed the alternative, due to its external debt to Germany and France; unlike domestic debt, external debt cannot be raised, paid and recycled back into the economy. Moreover, since the stability of the Euro is in part, dependent on the cumulative fiscal health of the member states, a 'no bailout' situation would damage the monetary strength of the union as a whole as well. Although initially, the 'no bailout' clause had a comparatively strong judicial presence, it was later replaced by directive measures and weakly enforced penalties at the behest of policymakers sceptical about its credibility (Hallerberg, 2010). Yet, it is incredibly important to strike a balance in an economic union where the member states' rights to their fiscal affairs cannot be upheld over the efficiency of the whole union. If done so, inefficiencies through the direct prohibitions on CG activities or by excessively decentralised legislatures giving more power to the SCGs may crop up (Inman & Rubinfeld, 1992).

5.0 Secessionist Movements

Another, well-feared consequence of an overly powerful SCG is the danger of secession and the eventual dissolution of the federalist structure. An OECD empirical analysis reveals that fiscal federalism as a whole endorses the economic convergence of the constituent regions (Sorens, 2012). However, the inference stands for federalist unions devoid of equalization programmes. Equalization programmes in the EU, specifically in inter-national redistributive schemes involving unconditional grants to member nations in need (which are virtually granted impunity due to the exclusion of the 'no bailout' clause), can sow the seeds of hostility in other members.

Moreover, Rode, Pitlik & Borrella (2017) in their empirical analysis of electoral data on separatist political movements reveal that European regions that have higher fiscal and institutional autonomy are more likely to be in favour of secessionist political parties. This has also been an explanation for the recent referendum results for Brexit, where the British populace, with higher institutional and almost complete monetary autonomy, voted in favour of seceding from the European Union. Theoretically, the devolution of SCG's fiscal powers can encumber secessionist movements. Formidable self-governance institutions can help keep a check on separatist activities. However, this can be paradoxically hindered by the same institutions in place, in solidarity with the region they govern, instead of the union they represent.

An alternate solution to this is "fiscal appeasement" where CGs can incentivise credibly secessionist SCGs to stay via monetary grants. This gains a greater significance in regions that have ethnically, linguistically, religiously discrete peoples. The SCGs there has a higher likelihood of sharing a sense of camaraderie with the people than the relatively demographically unfamiliar union. As a corollary to that, they can also possibly gain much greater political power in those regions which comes as a direct threat to the significance of the CG in the eyes of the people. Sorens (2015) states that CGs resort to fiscal appeasement in terms of "excessive" fiscal centralization stunting the growth of the SG in fiscal revenue. Additionally, CGs can also enact "excessive" decentralization of common market policies which would increase market competition (and lessen regional regulation) in those areas.

6.0 Current Situation

Eurozone members had been so shielded from the Global Financial Crisis in 2008 that non-member states were hit hard by Iceland and Latvia who had previously rejected the common currency considered holding referenda for the same (Hallerberg, 2010). In contrast, the Greek debt crisis had shaken up the EU members intrinsically, thus, alluding to the fact that the union can stay strong as long as the individual members cumulatively can stay unaffected by a negative shock. However, by the same principle, the current pandemic poses a formidable threat to the member economies as well as the state of the union.

6.1 Plan of the European Union

Owing to the economic loss during the pandemic, the EU has recorded a -7.9% GDP growth on a year-on-year basis. It is its first low in over a decade since 2008, and the lowest in its existence (OECD, 2020). For the first time, the EU deployed the maximum flexibility in its Stability and Growth Pact (SGP) on 23rd March, soon after the pandemic spread globally. Moreover, anticipating the gravity of the economic loss, the EUR 25 billion guarantee fund, "Support to mitigate Unemployment Risks in an Emergency" (SURE) was launched to aid dismissed and self-employed workers. Pandemic Crisis Support credit lines within the framework of the European Stability Mechanism (ESM) as well as other reforms were introduced in support of SMEs in April. Including the Coronavirus Response Initiative Investment, the EU Solidarity Fund, and the business aid via the ECB, fiscal measures amounting to roughly EUR 480 billion have been introduced since the pandemic commenced.

Also, the European Commission proposed a recovery plan, 'Next Generation EU' in May, to extend support to member states via sufficient financial reforms and investments; to boost the EU economy by providing incentives for private investments, especially, solvency support instruments and; to repair and learn from the crisis by investing in health, R&D, civil protection and external action, including humanitarian aid. Along with the previously determined aid, this recovery plan of 750 billion (OECD, 2020) adds up to almost upwards of EUR 1 trillion of fiscal expenditure. Despite the projected 6.1% GDP growth in 2021 ("Press corner", 2020)

6.3 The Common Consensus

The general sentiment is still not as optimistic amongst the uncertainty of the shocks. Particularly amidst the fears of a second wave, there is little hope of early recovery.

The sentiments amongst member states are dialectical. Despite the need for EU aid, the redistributive policies hurt richer nations that have already flattened the curve, namely, Denmark, Germany, and Sweden (WHO, 2020). Despite the plentiful aid provided so far, the macroeconomic credit risk assessment indicates, countries like Greece, Italy, and Spain have a high likelihood of default.

6.4 Solutions

A permanent solution in these unprecedented times cannot be a bailout; the Commission ought to plan for preventive rather than corrective schemes. For this, active involvement of the ECB is necessary for effective management of the state-level finances. The European Financial Stability Facility and the European Stabilisation Mechanism both need to be transformed into a permanent emergency solution rather than temporary mechanisms. Despite the aforementioned arguments revolving around greater centralisation (Fernandes, 2018), a pandemic demands a centralised, counter-cyclical federal fiscal stabilisation. Gehrke (2020) enumerates strategies for strengthening the manufacturing of pharmaceuticals and raw materials in Europe, in the wake of disrupted supply chains, along with concrete fiscal policies for vetting foreign investment.

On a long-term basis, several of Hallberg's (2010) solutions are still applicable in the contemporary context. A preventive mechanism in the SGP demanding the states to report their t+1 and t+3 economic plans annually to European Commission, along with clarification regarding their midterm budgetary objectives and how they plan to achieve them, is the most suitable of the lot. Moreover, the Commission evaluates the plans based on their viability and their suitability with the EC commissioned guidelines. It is also important to clarify the terms of "fiscal governance" domestically and reduce arbitrariness in the decision-making process. In the long run, for the EU to function smoothly, the SCGs ought to be subjected to harder budget constraints (Sorens, 2015) to ensure the slack in the economy does not drag on post the pandemic. To reinforce the fiscal and economic competencies of the member states once normalcy revives, the two most important aspects would certainly be the relaxing of the free EU markets and strengthening the institutions in member states.

The pandemic-instigated financial crisis has reinforced the necessity of fiscal discipline, active involvement of the ECB & the EC and a stronger institutional base in an inter-governmental context to effectively maintain the federalist structure of the EU.

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