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Which Budgetary Union for the E(M)U?

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Abstract

This article considers whether the creation of a budgetary union in the European EMU (economic and monetary union) is a feasible and suitable way to resolve the current impasse created by the euro crisis. The article begins by identifying the major drawbacks concerning the transposition of prescriptions regarding fiscal federalism to the current E(M)U scenario, with the outlook that this appears to be an extemporaneous solution. It then indicates the alternative conception of an incomplete budgetary union, which is mostly characterized by the setting up of specific insurance mechanisms. These alternative measures are shown to be more realistic and feasible, since they combine path dependency with an innovative appropriation of specific features of the classic federalism model, modifying them to an E(M)U scenario in a heterodox way.

Keywords: euro crisis; fiscal federalism; budgetary union; government insurance mechanisms

Introduction

The eurozone still faces today the effects of the 2007–08 financial crisis and the uncertainty about the future viability of the European EMU (economic and monetary union) and ultimately that of the EU (European Union) integration project as a whole. Several proposals have been made in the last few years aiming to identify possible solutions for the eurozone crisis. In the political field, recall that made by the French President, François Hollande (in an interview on 12 July 2015 to the newspaper *Journal du Dimanche*), when he claimed that the eurozone's future should involve the creation of a budgetary union managed by the new eurozone government. He also advocated that this process should be pushed by an 'avant-garde' group of European countries, considered the core countries of the EMU – France, Germany, Italy, Belgium, the Netherlands and Luxembourg. This proposal seemed to imply two possible and (different to how it appeared) mutually exclusive outcomes for the eurozone current impasse.

The first possible outcome, a *resizing solution*, involves the idea that the eurozone should be resized and include only the aforementioned EMU core countries. Resizing would involve reducing the number of its members for countries with identical economic structures and providing safe and sound exits for the others. This idea is not new but the euro crisis has emphasized its appropriateness. In fact, one of the most discussed issues about the EMU (and the EU as a whole) even before it was launched (see Padoa-Schioppa, 1987) was knowing whether it fulfilled the conditions to be qualified as an OCA (*optimum currency area*).[1] As mentioned by De Grauwe (2014, pp. 74–5), several

[1] Departing from the seminal article of Mundell (1961), the main conditions for an optimum currency area are, on the one hand, the mobility of factors of production including labour and, on the other hand, price and wage flexibility. As a result, when facing an adjustment problem, these two conditions are mechanisms that can grant automatic equilibrium to the participating economies. Furthermore, the similitude or symmetry of economic structures between countries belonging to the same currency area may also work out as a condition to reach the optimum.

studies conducted for the EU, particularly for the EU-15, concluded, on a consensual basis, that the EU is not an OCA. Nevertheless, at the same time, the conviction has prevailed that there is a subset of EU countries, the core countries, for which a monetary union is optimal. In the current EMU scenario (and for the whole EU) the main conditions needed for an OCA are not fulfilled because, and referring to De Grauwe (2014, p. 74), an environment of asymmetry in output and growth needs much more flexibility in the labour market to make a smoothly functioning monetary union possible, that is, to allow for the eurozone to become an OCA. The internal market, a pre-condition for the monetary union, was implemented in the EU (with the Single European Act, 1987) to ensure a free market environment, sound competition rules, and freedom of movement of goods, services and workers. However, the presence of cultural and institutional constraints has severely impaired the prospects of achieving complete labour mobility, overshadowing all the reforms that have been carried out over the years in European labour markets and ultimately reducing its effectiveness. Above all however – and again referring to De Grauwe (2014) – the main problem in the eurozone is the remaining environment of asymmetry in output and growth that further impairs an optimal result. In fact the EU, and particularly the eurozone, has epitomized, since the first enlargements of the 1980s, an integrated territory of economic differentiation (for example, GDP (gross domestic product) *per capita*) especially when one compares the core countries with peripheral countries and the recent crisis has particularly emphasized this 'capital sin'.[2] The resizing solution is certainly a very sensitive political decision and faces two types of unwanted drawbacks: (1) it could be considered a first step for the eurozone's disintegration and the euro could be at stake, and (2) 'safe and sound' exits for the non-core countries could involve heavy and unforeseen fiscal and economic costs for the remaining eurozone members and particularly for those that were to exit.

The second possible outcome, a *rebuilding solution*, implies setting up in the eurozone, side by side with the existing monetary union, a complete budgetary union. This idea is not new either, but the crisis has once again highlighted the fact that the eurozone is an incomplete monetary union and this is so precisely because it was built without a budgetary union (see De Grauwe, 2014, pp. 16–17). Furthermore, the creation in the eurozone (and ultimately for the EU) of a complete budgetary union would involve applying in the EU what Hinarejos (2013, pp. 1621–42) qualified as the 'classic fiscal federalism model', that is, it would imply transposing to the EU the basic prescriptions of fiscal federalism. The main purpose of the present article is therefore to investigate whether the enhancement of fiscal federalism in the EU is a feasible way to resolve the impasse created by the euro crisis. Departing from the identification of the referred prescriptions of fiscal federalism, I will then point out the specific drawbacks that can be foreseen in the aforementioned transposition that eventually hinders the creation of a complete budgetary union in the EU. In my view, a complete budgetary union seems to be an extemporaneous solution. Finally, I will address some possible alternatives to the classic fiscal federalism

[2] Eventually, as mentioned by McNamara (2015, pp. 21–43), the OCA framework is not able to explain the current crisis, at least in a complete way. Within McNamara's alternative approach, the eurozone's problems result from the fact that the zone is not an 'embedded' currency area. And 'embeddedness' is a condition for success, depending on four key elements: (1) a legitimated generator of market confidence and liquidity (a true lender of last resort); (2) mechanisms for fiscal redistribution and economic adjustment; (3) regulation of financial risk and uncertainty; (4) political solidarity.

model which despite assuming path dependency may nevertheless appropriate specific features of the classic model, and then develop them in a heterodox way.

I. The Creation of a Budgetary Union in the EU: Limitations Concerning the Transposition of the Classic Fiscal Federalism Model

Revisiting Fiscal Federalism Literature: The Main Prescriptions of the Classic Model

Fiscal federalism theory was established more than 60 years ago through the seminal works of Tiebout (1956), Musgrave (1959, 1983, Oates (1968, 1972) and Olson (1969).[3] A gradual evolution was then noticed in the literature on fiscal federalism. As mentioned by Ahmad and Brosio (2006, p. 1), the traditional, largely normative approach, was based on the assumption of a benevolent government. The subsequent research was considerably influenced by Public Choice (Political Economy approach) assuming that, unlike normative approach governments, politicians and officials act as self-interested players. Recent studies within the framework of this latter approach have added new topics to fiscal federalism theory,[4] and simultaneously compelled current normative studies to broaden their scope of analysis.

The conventional normative approach, in a departure from the generalized idea of 'finance follows function' (Boadway and Shah, 2007, p. xxvii), proceeds to establish the normative criteria for the following: functions assignment, tax assignment, intergovernmental transfers (for example, general objectives, types of transfers, microeconomic effects, equalization criteria) and local borrowing. While the first item corresponds to the expenditure side, the remaining three items correspond to the revenue side (the three main sources of sub-central financing).

With respect to the assignment of functions, Musgrave (1959), departing from his own taxonomy of government functions, claimed that the heart of fiscal federalism should remain within the allocation branch while the branches concerning the objectives of distribution and stabilization should have their primary responsibility at the central level. Contemporary studies conducted notably by Oates (1968) and Olson (1969) managed to identify within the allocation branch the general criteria for the function assignment. The geographical scope of the benefit ('perfect mapping' or 'fiscal equivalence') was the principal criterion used to identify whether the collective good was a local, regional or a national one and to determine, accordingly, the level of government to which the allocation function should be assigned. Notwithstanding, some other economic effects, notably the existence of spatial externalities or spill-overs and the verification of economies of scale (Shah, 1991, pp. 3–4), should also be considered, since they could potentially lead towards a *rationale* for upgrading the decision level, that is, a *rationale* for centralization.

[3] After the 1990s, the subject regained interest and since then more relevant studies were made under the auspices of international organizations like the IMF (International Monetary Fund), OECD (Organisation for Economic Co.-operation and Development) and the World Bank. A majority of the studies were initially disclosed as non-edited papers and eventually published as collective books (for example, books edited by Ter-Minassian (1997), Boadway and Shah (2007, 2009, and Shah (2007a, 2008). Other articles were published by the OECD, such as: Joumard and Kongsrud (2003), Bergvall *et al.* (2006) and Blöchliger and King (2006).

[4] Known as the second generation of fiscal federalism (Oates, 2005).

As for *tax assignment*, the contributions of Musgrave (1983) and Shah (1991, p. 13) should be recalled using, for that purpose, equity (consistency of revenue means with expenditure needs) and efficiency (minimizing resource cost) criteria.[5]

In the case of *intergovernmental transfers* (for example, *grants*), besides their main role of overcoming vertical fiscal imbalance they also fulfil equalization purposes and policy goals previously decided by the central government. General-purpose grants are more suitable for correcting vertical fiscal imbalance and promoting horizontal equalization, while specific matching or non-matching grants are more suited for the pursuit of policy goals.[6] Other aspects concerning intergovernmental transfers refer to microeconomic effects with respect to different types of transfers (income and substitution effects), and to equalization criteria ('fiscal capacity' and 'expenditure needs' criteria, which can, in turn, give rise to different distributional formulas – see Shah, 2007b, pp. 20–30).[7]

Sub-central borrowing, the final topic mentioned in fiscal federalism theory, having regained importance in the last two decades, is now under the influence of the political economic approach. Decentralization was previously criticized due to the fact that it either could prevent fiscal discipline (Tanzi, 1996) or it could result in bad governance, corruption and rent seeking (Prud'Homme, 1995). Both criticisms are affiliated with the Public Choice Leviathan model, and were a starting point for studies focused either on the relationships between 'decentralization, common pool problem and pork-barrel politics', or on the relationships between 'sub-central borrowing, soft budget constraints and bailout'. It should be noted that precise seminal studies on these subjects[8] coincided with the launching of the Stability and Growth Pact – SGP framework (1997) that enforced quantitative rules for Member States' deficits and debt (see details in Philip, 2002).

Application of the Classic Fiscal Federalism Model in the EU and its Specific Drawbacks

The attempt to bring fiscal federalism's normative prescriptions to the EU is not new, as established by the *Marjolin Report* (Marjolin, 1975), *MacDougall Report* (MacDougall *et al.*, 1977), the *Padoa-Schioppa Report* (Padoa-Schioppa, 1987) and the '*One Market One Money*' *Report* (Emerson, 1990). In the economic literature, seminal contributions from Wyplosz and Pisani-Ferry (1990) and Sala-i-Martin and Sachs (1991) should be recalled. It is true that an optimistic idea prevailed (for instance, in Emerson, 1990) that the European monetary union would achieve positive outcomes vis-à-vis the Member States, notably because asymmetric shocks would be less frequent and smoothed by the single monetary policy (about this belief, see Bénassy-Quéré, 2015, p. 72). Nevertheless, it is also true that most of the functional problems that the EU is facing

[5] These basic criteria are the following: (1) progressive redistributive taxes and taxes suited for economic stabilization should be centralized; (2) taxes on mobile factors should be centralized (in order to avoid beggar-my-neighbour policies and trade leakages); (3) resident-based taxes such as taxes on sales or excises are better suited for states; (4) taxes on immobile factors are best suited for the local level; (5) benefit taxes and user charges should be used by all levels. Moreover, tax assignment can involve concurrent exploitation of tax bases by different levels of governments: most notably in the case of 'piggybacking' or when different levels of the government apply their own rates to the same tax base.

[6] See Bergvall *et al*. (2006), Shah (2007b) and Boadway (2007).

[7] Also notice that intergovernmental transfers should not be confused with *tax sharing*, even though mixed arrangements can exist. In fact, as referred to by Blöchliger and King (2006, tax sharing is an arrangement wherein a certain amount is allocated, in an automatic and pre-determined way, to each level of government out of the total revenue (generated from a single tax or a pool of taxes).

[8] Wildasin (1997), Ter-Minassian and Craig (1997), Joumard and Konsgrud (2003), Ter-Minassian (2006) and Vigneault (2007).

today were identified early. Particularly, we can verify how avant-garde the *MacDougall Report* was in its anticipation of specific drawbacks along with the measures and steps that should be taken in order to enhance fiscal federalism in Europe.[9] One of the most important alerts made then was that a fiscal federation was a pre-condition that would facilitate the creation of a monetary union (MacDougall *et al.*, 1977, p. 21). For countries deprived of external mechanisms of adjustment (trade barriers or currency devaluation), the inexistence of a central public finance system prevents them from adjusting, for instance, in the case of a fall in the demand for its exports or a rise in the respective price (MacDougall *et al.*, 1977, p. 34). This leads us, retrospectively, to the conclusion that a majority of the crucial problems that the EU and the eurozone face today are a consequence of its fragile foundations, and one of the reasons is that a budgetary union should have preceded, not succeeded, the monetary union.

Even if in a haphazard manner, it is certainly a fact that specific features emphasized by the normative fiscal federalism theory were meanwhile adopted in the EU. I will mention three main examples related to the assignment of the aforementioned functions. First, with regard to the *macroeconomic stabilization function*, the idea that responsibility should remain with the central government has already been partially accomplished in the EU as monetary policy is conducted by the ECB (European Central Bank). However, it should be borne in mind that the territory of the centralized monetary union is not the EU, but a smaller area within the EU, the eurozone. In fact, unlike that which seems to be assumed by the insights of fiscal federalism, European integration has created a disjointed territory where monetary policy is mostly restricted to the eurozone (managed by the ECB and the Eurosystem), whereas the central budget corresponds to the EU as a whole. Nevertheless, paradoxically, this same budget was not made to accommodate fiscal policy with macroeconomic stabilization purposes (as mentioned below). On the contrary, the only existing mechanisms for stabilization effects once again have a more limited territorial scope, corresponding not to the EU, but to the eurozone. This is the case with the ESM (European Stability Mechanism), created in 2010 to provide financial assistance to countries in need, the institutive Treaty of which came into force in 2012. This means that stabilization is not a role of the EU budget but of an 'outsider' mechanism with particular rules for financing Member States, limited territorial scope and incomplete effectiveness (it ensures financial stabilization, not overall macro stabilization). Second, concerning the *allocation function*, it can be established that the completion of the internal market is in line with the prescriptions of fiscal federalism. In fact, the creation of a level playing field in terms of competition, for the whole territory, is a way to prevent beggar-my-neighbour policies that might occur in the absence of common rules. It is also true that, within the same internal market, the EU has evolved to centralize powers in areas characterized by externalities or economies of scale, for instance, R&D, transport and communications, and regulatory policies. Furthermore, in other areas, the EU has also increased its powers with the assistance of the aforementioned normative insight of 'fiscal equivalence', which establishes that whenever the scope of the benefit corresponds to the central level the provision of the goods should be centralized (for example, foreign aid and external affairs). Normative prescriptions have given a *rationale* for centralization in the above-mentioned cases, as they have sustained – first and foremost –

[9] See also Denton (1977).

decentralization in the EU. In fact, the EU's fundamental *principle of subsidiarity* (which constitutes along with fiscal equivalence a functions assignment principle) has also supported the previously mentioned premise of fiscal federalism (from Musgrave) according to which, unless proven otherwise, the core of decentralization relies upon the allocation branch.[10] Social policies, such as education and health, are typically cases for decentralization to Member States (or to their respective sub-central governments) on the grounds of subsidiarity and fiscal equivalence. In the third place, concerning the *distribution function*, the EU already has financial instruments that exhibit an inter-regional redistributive impact, albeit in a restrictive manner. That is the case of the Structural Funds, as referred to below.

Despite, the progress made to embrace the ideas of fiscal federalism, the gaps between prescriptions of normative fiscal federalism and the EU's reality are greater than the accomplishments. As a note of caution I should recall that E(M)U′s political and institutional background certainly explains many of the difficulties – (1) with the EU not being a sovereign country, the sense of cohesion is weak,[11] explaining, for example, taxpayers' resistance to finance mechanisms of risk sharing which may imply some moral hazard; (2) the EU's political system is atypical and lacks sufficient democratic support, which should be a basic condition for fiscal federalism to work properly; (3) the fact that the EU is not (yet) an all-purpose organization prevents the complete applicability of normative criteria concerning the allocation of central collective goods (for example, Defence) that should be thus provided by the central level – the EU level – and yet remain with sub-central governments; (4) in the EMU, the central level has the power to issue money but has no political sovereignty (a currency without a state), whereas the Member countries (the sub-central level) being sovereign are though deprived of money issuing power – and this is also atypical in the light of fiscal federalism theory, creating difficulties notably when it comes to assigning stabilization functions.

As for the specific drawbacks vis-à-vis fiscal federalism's prescriptions, and starting with *functions assignment*, the most important divergence can indeed be found in the *stabilization branch*. Unlike what happens in most OECD (Organisation for Economic Co.-operation and Development) countries (unitary or federal countries), the EU budget is not capable of ensuring the macroeconomic stabilization function since it is too small in comparison with national budgets. This characteristic of the EU budget, since its inception, has not seen much change from its initial (related to the EU's GDP) to its current dimension. Hence, as pointed out by De Grauwe (2014, p. 18), the EU's budget amounts to only 1 per cent of EU GDP while national budgets typically absorb 40–50 per cent of GDP. The simple existence of a central budget, a system of collecting taxes and assigning expenditures, allows for stabilization mechanisms to operate whenever regional shocks occur, working as a government insurance mechanism. Moreover, in a fiscal federalism system stabilization can occur not necessarily in a direct and 'visible' manner through specific stabilization mechanisms (for example, intergovernmental cyclical grants), but also through general inter-regional redistributive mechanisms (for example,

[10] On the historical foundations and the reception of the principle of subsidiarity by the EU Treaty, see Toth (1992). On the principle of subsidiarity as a functions assignment principle, see Dafflon (2006).

[11] Lacking a 'common identity', to use the words of Verdun (2010) when referring to the EMU. McNamara (2015, on the other hand, refers to the EU as a 'novel hybrid' with some components of a federal state, but where key powers remain with the Member States.

intergovernmental transfers or grants, referred to further on) or even through inter-individual redistributive instruments (for example, personal taxes and social benefits) provided by the central budget (recall that according to Musgrave's taxonomy, inter-individual redistribution is mostly a responsibility of the central government). Accordingly, it can be concluded that the stabilization branch goes hand in hand with the redistribution branch. Above all, as referred to in the *MacDougall Report* (MacDougall *et al*., 1977, p. 36), it has been validated that both personal income tax and social security benefits, being instruments of economic redistribution, also act as 'invisible' mechanisms able to correct regional macroeconomic imbalances: high incomes go with high tax payments and low incomes go with high revenues from central government (p. 13).[12] The fact remains that due to its small dimension and because the centre is deprived of important fiscal policy instruments, both on the tax and the expenditure side, the EU's budget cannot properly manage the stabilization function. Moreover, with reference to the expenditure side and due to the principle of subsidiarity, the EU is also deprived of a substantial part of social policy instruments (namely, social security benefits that can operate as automatic stabilizers) that could effectively contribute towards stabilization in the case of macroeconomic shocks.[13] Last but not least, mention should also be made of the specific nature of the EU's budgetary system, wherein the annual budget is integrated within a MFF ('Multiannual Financial Framework').[14] Framing the annual budget in a medium-term document of expenditure planning helps to achieve fiscal discipline. Nonetheless, the rigid nature of expenditure headings set down in the MFF hampers the EU's budget capability to respond to adverse shocks and obstructs any counter-cyclical policy (Tondl, 2000, p. 236) thereby jeopardizing the capability of the EU's budget to ensure macroeconomic stabilization. Although this problem is not new, the recent changes in the EU's Treaty (introduced by the Lisbon Treaty in 2009) have not changed the status quo.

As for *tax assignment*, it can be verified that most of the prescriptions of fiscal federalism fail to apply. Departing from the aforementioned assignment rules developed by Musgrave (1983), it is obvious that the EU does not fulfil the criteria or at least not with respect to all types of taxes. It is true that for indirect taxation, the current set-up closely resembles a federal system. First, because there is legal harmonization in the EU concerning VAT (value added tax), and second because tax harmonization is a good condition to sustain 'piggybacking' amongst different levels of government. What is more, 'piggybacking' does in fact occur: part of the VAT revenue is actually assigned to the EU's budget, corresponding to a uniform rate of 0.3 per cent levied on the harmonized VAT base of each Member State. It should also be noted that VAT harmonization and the respective 'piggybacking' mechanism are also in accordance with normative fiscal federalism, in the sense that centralization in general consumption taxes is a way to prevent distortions that can affect the functioning of the common market. However, with

[12] Notice however that this stabilizer role is not only due to the central budget's action, notably via taxes and transfers vis-à-vis individuals and regions. Departing from the primal contribution of Asdrubali *et al.* (1996), Wolff (2012, p. 3) states that capital and credit markets may play a more important role for stabilization. Capital markets stabilize regional shocks as long as the ownership of the asset is not concentrated in each region – financial integration hence works as a private insurance mechanism that can be as much or even more effective than government insurance mechanisms.
[13] Further on, related to this issue, I will refer to some proposals related to the creation of a European unemployment benefit scheme, and I will address its targeted role as a macroeconomic stabilizer within EU Member countries.
[14] Recall that the current package is the MFF 2014–20, which is mostly related to the implementation of the Lisbon Strategy and the achievement of the so-called 'Europe 2020' objectives.

VAT harmonization the EU's resemblance to a federal tax system ends. Unlike that which happens with indirect taxation, personal income tax, with redistributive purposes, is not assigned to the central level and hence remains payable to the intermediate level (the Member States). On the other hand, within the EU's own resources system, it can be affirmed that the GNI (gross national income) tax revenue (through which each Member State transfers a standard percentage of its GNI to the EU) does not have the profile to become a central personal income tax. Furthermore, the creation of tax-sharing or 'piggybacking' mechanisms, which allows for the central government to share the same tax base with national governments and, based on that, to define some sort of progressive tax arrangement related to this kind of tax in the EU, does not seem plausible in the short to the medium term. Lastly, in general terms, it can be said that despite the 2014 reform of the EU's own resources system, the criticisms made by Begg (2009, pp. 36–40) and Dullien and Schwarzer (2009, p. 163) remain pertinent: national contributions have a limited connection to fiscal federalism theories, not taking properly into account Member States' wealth and also face several distortions, as is the case with the UK rebate.

Concerning *intergovernmental transfers* (*grants*), the gaps between theoretical proposals and the EU's reality are also significant. As previously stated, grants serve two main purposes: to correct vertical fiscal imbalances that occur whenever there is a mismatch between revenue means and expenditure needs (a shortfall suffered by the lower level of government), and to correct horizontal fiscal gaps, that is, to promote internal cohesion and equalization. Strangely enough, since the process of decentralization in the EU is a 'reverse-type' process fed by the subsidiarity principle, the resulting vertical fiscal imbalance suffered by the Member States is a *natural state*, to the extent that it cannot be corrected. Hence, the creation of general-purpose grants aiming to redress vertical fiscal imbalances is not part of the discussion. On the contrary, the topic of fiscal equalization has not been ignored and has gained importance with the euro crisis. The equalization objective is two-fold – there is a short-term perspective where it serves as a fiscal instrument to ensure, in each moment, the correction of horizontal imbalances between regions of the same country; and a long-term perspective, the theoretical origins of which are long-term growth theories and trade theories, where equalization is related to convergence purposes. In fact, the EU's main inter-regional redistributive instruments – the European Structural Funds appear quite commonly in relation to convergence issues (see Shankar and Shah, 2009). The fact is that the existing funds have not been conceived of as typical equalization instruments, able to correct horizontal imbalances and cope with differential net fiscal benefits across states. This happens primarily for the following reasons: first, even though most of these funds (for example, the Cohesion and the European Regional Development Funds) have had low-income states or regions as previous beneficiaries, they do not include redistributive formulas, typical of equalization transfers, based on fiscal capacity (for example, macro indicators or the representative tax system) or expenditure needs (for example, ad hoc criteria or the representative expenditure system); second, these funds are ear-marked grants (for example, environment, R&D, small and medium-sized enterprises) and not block grants with the principal purpose of inter-regional redistribution; third, most of these grants are also matching grants which involve financial effort from both the donor's and recipient's side, an effort that sometimes the latter is not in a condition to make. The current design of intergovernmental transfers in the EU is conceived to counteract typical problems that occur in these kinds of transfers, properly highlighted by the second generation of fiscal federalism theory, notably moral hazard issues, the common pool problem and pork-barrel politics. But this implies a trade-off: the loss of an unconditional equalization mechanism, based on fiscal capacity, that would 'assure to poor, small and peripheral member states economic, welfare and public services standards not too far below those of the main body of the Community' (MacDougall *et al*., 1977, p. 64).

The second generation of fiscal federalism theory has, as well, embraced the topics of *soft budget constraints*, *sub-central borrowing and bail out*. These are in fact well-known aspects of the EU's fiscal coordination system created by the EU Treaty and the SGP, just as they have hardened budget constraints, limited Member State deficits and debt, and prohibited a bail out. Notice that the design of fiscal rules enclosed in the SGP was sustained by an inflation aversion perspective and accepted as a way 'to discourage free riding and induce governments to internalize the negative externalities otherwise imposed on the EMU partners' (Eichengreen, 1996, p. 4). However, the SGP would exhibit its shortcomings from the very beginning: rigidity vis-à-vis the business cycle and apparent indifference to economic growth. Moreover, in the aftermath of the SGP's first crisis (that would lead to the 2005 Reform), some had already pleaded for the need to substitute this disciplinarian view with an insurance device complementing the SGP framework and yet controlling moral hazard (see Schelkle, 2005). The euro crisis has highlighted once again this insufficiency: the disciplinarian view tends to be self-defeating in a territory of economic differentiation and financial fragmentation, where private insurance instruments do not work properly and are furthermore deprived of government insurance mechanisms.

II. Alternative Solutions to the Classic Fiscal Federalism Model: The Incomplete Version of Budgetary Union

Considering the specific drawbacks previously referred to, it seems quite difficult to consider the adoption of the 'pure' model of classic fiscal federalism for the EU. Even when adopting a quantitative reduced version, similar to the one proposed in the *MacDougall Report* (entitled as smaller public sector), it would imply a significant increase in the EU's budget as a percentage of the respective GDP. The 1977 proposal was to increase this by up to 5–7 or 7.5–10 per cent if Defence was included (MacDougall *et al*., 1977, p. 14). Above all, as mentioned by then, fiscal federalism should have preceded monetary union and it now seems as an extemporaneous solution. However, the reform of the design of the monetary union, as a way to overcome the euro crisis has definitely entered the European political agenda. The future reform of the E(M)U must, therefore, bring into play options different from the classic fiscal federalism model, even if certain features of the original model can be appropriated (and they are not necessarily new or unknown options) – this will be, in my opinion, an incomplete (and heterodox) version of the budgetary union.

I will therefore explain the notion of *incomplete budgetary union* addressing the following topics: (1) beginning with identifying which policy measures should be excluded and included in this notion; (2) classifying these policy measures according to three selected approaches.

Policy Measures Excluded and Included in the Notion of Incomplete and Heterodox Budgetary Union

By definition, all measures of monetary policy *should be excluded* from the notion of incomplete budgetary union, including non-conventional measures implemented by the ECB supporting government debt in the secondary market (for example, quantitative easing) – as was the case with the OMT (open market transactions) programme implemented from 2012 onwards. In fact, even though this is a tiny move made by the ECB to act as a 'lender of last resort' (see De Grauwe, 2011; Gros, 2015), the fact is that the OMT programme is still a monetary policy-type measure and not a budgetary-type one.[15] By definition, we should also exclude from this notion all measures taken to ensure a more effective functioning of the aforementioned private insurance mechanisms, for example, measures aiming to address financial fragmentation within the eurozone or to prevent market rigidities. This is the case, for example, with the banking union launched in 2013, and this is also the case with the so-called Macroeconomic Imbalance Procedure created in 2011 (as one of the new elements introduced by the '*Six Pack*'),[16] the main purpose of which was to prevent macroeconomic imbalances in non-fiscal areas such as private leverage or unit labour costs (Bénassy-Quéré, 2015, p. 77 and Micossi, 2015, p. 138), either by preventing the regional concentration of credit risks (and once again fragmentation of financial markets) or by ensuring wage flexibility in each of the eurozone members (recall that this is a pre-condition of an OCA). It is a fact that private insurance elements that can be found in the banking union and in the Macroeconomic Imbalance Procedure can be quite effective and partially offset the lack of government budget insurance mechanisms. However, their scope is limited, at least for the time being, and they will not be able to prevent or solve all types of asymmetric shocks in the EU or in the eurozone.

In the notion of incomplete budgetary union measures that imply expenditure for the EU budget *should therefore be included*, even if in an indirect way. In fact, special agencies or funds can be created to provide for expenditure but ultimately the cost will be borne by the EU's taxpayers. Moreover, this notion includes all sorts of measures properly designed to face macroeconomic imbalances, or asymmetric shocks hitting European countries, and that can function as *government insurance mechanisms* (*lato sensu*). These mechanisms are hence conceived in a pragmatic way, conscious of the current EU's budget limitations and having therefore given away the idea of creating a complete budgetary union. Because of this (because the EU cannot function in a complete fiscal federalist environment) these stabilization instruments are mostly *direct and visible insurance mechanisms* and not invisible ones, because the invisible action of budget instruments for stabilization purposes requires a larger budget and a set of taxes and expenditures fulfilling its usual tasks. It should be recalled that this invisible action is related either to general inter-regional redistributive mechanisms (for example, grants coping with a horizontal fiscal gap) or to inter-individual redistributive instruments (for example, personal taxes and social benefits) provided by the central budget. In my opinion, there does not seem to be, in the next few years, sufficient economic and political conditions to increase the EU's

[15] Generally speaking, measures included in the concept of quantitative easing are monetary policy measures, mostly because they lead to an increase in the monetary base.
[16] Regulation (EU) No. 1174/2011 of the European Parliament and of the Council of 16 November 2011 on enforcement measures to correct excessive macroeconomic imbalances in the euro area.

budget, not even to attain the percentage of 5 per cent regarding the EU's GDP, considered by the *MacDougall Report* as the minimum needed percentage to ensure the aforementioned invisible action.

Classification of the EU's Stabilization Mechanisms

The seminal contributions made on this topic (Sala-i-Martin and Sachs, 1991; Von Hagen, 1992; Pisani-Ferry *et al*., 1993),[17] assumed a fully federal model in which actual spending and revenues were shifted to the euro-area level (Pisani-Ferry et al., 2013, p. 4). However, the fact that the current structure of the EU's revenues and expenditures is not yet able to provide for this kind of invisible, automatic stabilization, justifies the design of specific insurance mechanisms (Bajo-Rubio and Díaz-Roldán, 2001, p. 7). In the design of the specific insurance mechanism two issues should be addressed: first, which concept of shock should be adopted (asymmetric or symmetric shocks, temporary or permanent); second, which indicator of shock should be used considering that it must provide good information on the cyclical changes in real output (for example, change in the unemployment rate, output gap) (see Bajo-Rubio and Díaz-Roldán, 2001). On the other hand, the insurance mechanism must present some adequate characteristics: it must be simple and automatic; it must avoid moral hazard; it must avoid wide coverage and guarantee budget neutrality so that regions not hit by the shock should contribute relatively more and only the regions affected should receive transfers; the whole amount collected should be always distributed, avoiding deficits and superavits concerning the mechanism (also see again Bajo-Rubio and Díaz-Roldán, 2001).

Departing from these characteristics, three kinds of approaches can be identified as a way to catalogue the main proposals regarding specific insurance mechanisms. The first approach – let's call it the '*cyclical budget approach*' – corresponds to the proposal made by Enderlein *et al*. (2012, pp. 30–1) of creating an *automatic cyclical adjustment insurance fund* that would work on the basis of contributions by national budgetary authorities (or national social insurance schemes) to a euro area fund in which receipts could serve as 'buffer' to be used in a downturn. The so-called *automatic transfer scheme* (Pisani-Ferry *et al*., 1993, 2013; Wolff, 2012) works in a similar way. The idea would be to complement the SGP, which is founded on the net budget balance of the business cycle effects, with a system of financial support based on the business cycle (Wolff, 2012, p. 8). It would therefore consist of a simple rule building on the current fiscal framework: deviations of output from the potential would trigger support payments; the scheme would involve borrowing during recessions and balancing out only over the business cycle (Pisani-Ferry *et al*., 2013, p. 5).[18] The second approach, which I call the '*debt pooling approach*' is founded on the Eurobonds model[19] and permits Member States to borrow even in situations of stress. One proposal in this stance is the *guaranteed bonds quota*, which consists of issuing mutual debt with a repayment guarantee given to the lenders (Pisani-Ferry *et al*., 2013, p. 5). This proposal departs from the existing ESM, recognizing that market

[17] On this topic, see Bajo-Rubio and Díaz-Roldán (2001).
[18] On this approach, see also Delbecque (2013).
[19] An initial version of this model was the 'Blue Bond proposal' made by Delpla and von Weizsäcker (2010): EU countries should pool up to 60 per cent of GDP of their national debt as senior debt, thereby reducing borrowing costs. On the contrary, red debt (beyond that percentage) would be issued as national and junior debt, claiming an enhancement of fiscal discipline as a way to prevent an interest rate premium.

access can dry up and enabling, on a conditional basis, Member States to borrow via the ESM at lower interest rates. The scheme would rely on the issuing of Eurobonds as a percentage of GDP that would notably be intended to serve as a buffer for states willing to borrow in times of stress before they had to apply for a fully fledged ESM programme (Pisani-Ferry *et al*., 2013, p. 5). Enderlein *et al*. (2012, pp. 37–41), on the other hand, propose a EDA (*European Debt Agency*) that would issue its own bonds and create a liquid market of Eurobonds. Countries in economic difficulties could increase their debt issue through the EDA to up to 20 per cent of their GDP without strict conditions. However, requests for further increases would be negotiated and subject to strict conditionality (for example, implementation of structural reforms). The latter approach, that I call the '*narrow automatic stabilizers approach*', is consistent with the creation of a EUBS (*European unemployment scheme*). I call it a narrow approach since it considers only one part of the automatic stabilizers that would also include, in a complete budgetary union, corporate and personal taxes, and other types of transfers as well. According to Dullien (2013, p. 9), under the EUBS scheme eligible unemployed individuals in the Member States would receive individual benefits from a European unemployment insurance, financed by contributions paid on the wage sum of covered workers. Over the cycle, contributions cover all payouts, with it being expected that the scheme is able to build up reserves (in good times) and borrow on the capital markets (in economic downturns) (Dullien, 2013, p. 14). For the insurance scheme proposed, the simulation presented shows evident stabilization effects, stronger than those found for the United States federal state system of unemployment insurance in previous simulations made by Von Hagen (1992), Asdrubali *et al.* (1996) and more recently by Wolff (2012).

Lastly, I would like to refer to three common features that can be found in these insurance devices. The first feature is that as they are specific insurance mechanisms each of them can ultimately be implemented outside the EU budget and be managed autonomously by bodies of the respective institutions/funds – see, for instance, the proposal for the creation of a Debt Agency. In this sense, they can be implemented without requiring 'any transfer of sovereignty in budgetary and fiscal policy' (Delbecque, 2013, pp. 3–4). The second feature is that, also due to their specific nature, these mechanisms are expected to act as a complement either of central private shock absorbers (the case of the banking union) or of Member States' own government stabilizers.[20] Finally, it should be noticed that these mechanisms are typically eurozone instruments and hence their geographical scope is confined to euro area members (Wolff, 2012, p. 8). In fact, most of the simulations limit themselves to countries in the euro area and this happens because we are dealing with prospects for a smooth functioning of the eurozone as a monetary union. Eurozone members should be able to collectively solve their own problems and it is certainly true that there has been a strong political pressure towards this split solution (recall, for example, the UK's usual position, setting aside any responsibility for the eurozone's problems). The main exception to this stance can be found in Beblavy *et al*. (2015, p. 17), concerning the introduction of the EUBS. The authors include all the EU Member countries, and this for the following reasons: first, because if the purpose of the scheme is to insure countries against asymmetric shocks, then a larger pool of countries is better

[20] For instance, the EUBS may work as a cap whenever national unemployment benefits are of a lesser amount, but not prevent the payment of higher benefits from the national scheme.

than a smaller one; second, because this would impose some minimal common standards, in terms of welfare, across the whole EU and demonstrate citizenship solidarity at the European level.

III. Final Remarks

The purpose of this article has been to highlight the specific drawbacks found in the transposition to the EU of the fiscal federalism model. This explains why it does not seem feasible to build, in the current scenario, a complete budgetary union. Nevertheless, there are some realistic alternatives to this pure solution that can properly work as stabilizers for macroeconomic imbalances, if well-conceived and designed. In fact, specific and automatic insurance mechanisms appear to be feasible and realistic solutions because they assume path dependency and accept evolution in considering the existing background, that is, the EU budget's current size and shape and the weak conditions to make it grow suitably in the next few years. At the same time, these mechanisms seek to resolve moral hazard problems in the sense that they all rely on incentives for fiscal discipline enhancement. Indeed, they appear to complement and reinforce the SGP's framework and provide it with a new argument, which is a good condition to grant them political acceptance. Finally, howsoever, it can be claimed that with these solutions the EU's budget liberates itself from the ambition of becoming a universal budget with full government functions, and reconciles itself with its peculiar nature of being a sectorial and targeted budget assigned with incomplete government functions, therefore being a defective version of the pure fiscal federalism model.

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