The Implications of an EU Fiscal Union for Local and Regional Authorities

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Executive Summary

The current move of the Euro Area towards the creation of a fiscal union represents a turning point for LRAs and is likely to have significant consequences that shall be properly understood.

In this report, Claire Dhéret, Francesco Nicoli and Fabian Zuleeg analyse the implications of the integration of the European fiscal and budgetary governance for LRAs. The aim of this report is to provide a useful tool to frame the discussion concerning the opportunities and challenges that a full-fledged fiscal union may raise in Europe.

To start with, the authors shed light on the features of a full-fledged fiscal union, based on the US example, and compare them with the current European situation. Based on this comparison the authors conclude that, although a series of important reforms and new measures have been adopted, the EU is still far from being a full-fledged fiscal union. In particular, the authors underline that the legal framework currently implemented is not strong enough to ensure proper crisis prevention. Against his background, the authors suggest a model based on three pillars –an independent budget for the EU (1), coordinated budgetary procedures (2), and independent national budgets at the national level (3) - that could provide a long term vision for a fiscal union in Europe.However, it should be reminded that such a move would be a long-lasting process only doable with the political will of national leaders.

In the second section of the note, the authors assess the consequences of the current measures adopted by the EU as regards fiscal policy and governance. Seven main findings arise from the analysis: the introduction of a coordinated process of fiscal governance has been a long-lasting process acceleratedby the crisis (1); the introduction of budgetary discipline within different MS emerged alongside, and occasionally, following the input of European policies (2); the process of fiscal governance seems to take two directions: fiscal decentralisation on the one hand, and Europeanisation of fiscal policy on the other hand (3); the effect on regional tiers seem to be twofold: from one side, their autonomy is restricted, especially in regions with direct taxation powers; on the other, their bargaining power towards the central state is increased (4); direct and indirect implicationswill emerge for LRAs, including the alignment of regional budget cycles with European rules and the shift towards multiannual budgetary planning (5); the more autonomy a regional authority enjoys within the national framework, the more likely the new European governance will affect its powers and decision making process (6); there is a lack in theoretical and empirical literature concerning the effects of a full-fledged fiscal union over LRAs (7).

In addition, the authors also analysethe impact of the threefold model of fiscal union presented in section 1 on LRAs and argue that it would both raise opportunities and challenges for EU institutions and LRAs, ranging from greater recognition of the responsibility of LRAs, increased bargaining powers, stronger cooperation between the European and the subnational level to possible increase in administrative costs and a macroeconomic conditionality that could be applied to the regional level instead of the national one.

Last but not least and following the study findings, the authors list three main recommendations aimed at ensuring the success of a European fiscal union. Firstly, they suggest that any progress towards a full-fledged fiscal union shall be achieved in the full respect of the subsidiarity principle, deploying policies and responsibilities at the governance tier where it appears to be more effective and appropriate. Secondly, a full-fledged fiscal union, if applied at a heterogeneous community like the EU, shall be designed to achieve policy dissemination and coordination, and will require direct involvement of the LRAs at EU level for the design of the policies of their competence. Finally, we believe that on the long term a true fiscal union must be empowered with a true EU budget enabled to pursue discretionary spending and investment, not least to help regions exit the economic crisis.

Introduction

Against the background of the economic and financial crisis, the debate over the future of the European integration has significantly increased over the recent months. In particular, the consensus concerning the need for moving towards a fiscal union for the Euro Area seems growing. The reasoning is straightforward: not only would a fiscal union help to solve the current crisis, but it would also prevent other similar crises from emerging. Indeed, the idea that the monetary integration shall be completed with a fiscal pillar exists since the very beginning of the discussions concerning the European Monetary Union (EMU). Fiscal integration was already proposed in 1970 with the Werner Report, and since then, cyclically emerged in the discussions. With the launch of the new economic governance in 2011, the integration process has been accelerated: nowadays, without being yet a full-fledged fiscal union, the Euro Areadoes no longer represent a group of states enjoying full fiscal sovereignty.

Beyond its name, however, little consensus exists on what a fiscal union shall look like. Several models have been proposed: some of them emphasising the fiscal transfer component of the union, while others relying more on fiscal unions' capacity to shape responsibility of contracting parts.

Moreover, if many analysts and scholars take into account the impact of such agreements on national economies, little is said about potential effects on regional and local tiers of government. Nevertheless, the introduction of stronger fiscal integration among Member States (MS) is expected to impact on regional and local level, even if it is still uncertain how these concrete implications will look like as they depend on a series of factors. The creation of a fiscal union in the Euro Area represents therefore a turning point for local and regional authorities(LRAs) and their interaction with the national and European levels, and shall be properly understood. The aim of this report is to provide a useful tool to frame the discussion.

This file note is structured around two main sections.The first section entitled 'Towards a true European Fiscal Union' is organised as follows: firstly, the authorsanalyse the features of the US fiscal union; secondly they present the macroeconomic rationale discussed in the current debate for displaying a fiscal union over the European Union; thirdly, they discuss the current state of play concerning fiscal and economic governance in Europe, and fourthly, they suggest a threefold model of full-fledged fiscal union based on fiscal unions' characteristics and the particularities of the European Integration, providing actual democratic legitimacy for its choices.

The second section discusses the implications of the European Union's (EU) current move towards a fiscal union for LRAs. Firstly, theeffects of the six pack, two pack and fiscal compact areanalysed and a particular emphasis is put on the impact of these measures on national fiscal frameworks, on internal negotiation procedures among government tiers, and on regional budget cycles. Secondly, the impact of the threefold model of a full-fledged fiscal union presented in section 1 is assessed, with the specific goal of understanding challenges and opportunities for LRAs.

The conclusions of the note recall the main findings of the study and propose a set of policy recommendations that could be pushed forward by the Committee of the Regions.

PART 1: Towards a true European Fiscal Union

1.1 Building blocks of a fiscal union

1.1.1 The current debate

Over recent months, the European political scene has witnessed a range of declarations and calls for establishing a fiscal union among Euro Area countries. Many think that the only solution to the economic crisis is further fiscal integration. However, this consensus often ends when the debate focuses on the content of this fiscal union. For example, German negotiators[1] often consider a fiscal union as a form of stricter budgetary integration, with a joint responsibility on budgetary surveillance, supranational enforced spending limits, and automatic sanctions for non-complying MS. Other MS refer to debt mutualisation and fiscal transfers as key elements of fiscal union,[2] while others consider the creation of a larger European Budget including certain spending chapters such as unemployment benefits or pension spending as an essential building block for a fiscal union. Moreover, other proposals - like a banking union, or the extension of the ECB mandate to be lender of last resort for sovereigns -, while not representing *per se* a fiscal union, imply important indirect steps towards fiscal integration.

In order to provide a clear and useful contribution to the discussion and clarify the object of this study, the first section of this report will look at one already functionning fiscal union, and compare it with the current state of play in Europe. This section first examines the fiscal union in the United States (US), which is often cited as a potential example for the EU. Secondly, the report presents the reasons why similar arrangements in Europe should be introduced. Thirdly, the report describes the current state of play in Europe and the recent initiatives to strengthen European economic governance and adopt a form of fiscal union. And fourthly, the authors will look at the missing elements required to establish a full-fledged fiscal union for the Euro Area.

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[1] This was for example the position of the German ministry of Economics, Roesler, who called for automatic sanctions at EU level; (http://www.bloomberg.com/news/2011-12-01/germany-s-roesler-wants-more-automatic-eu-sanctions-welt-says.html); similar positions were expressed concerning fiscal compact agreements from the German Chancellor, Merkel (http://www.irishtimes.com/newspaper/world/2012/0201/1224311048420.html) and from German Finance Minister, Schaüble, who called for a EU Finance Minister with veto powers on MS' budgets. http://www.spiegel.de/international/europe/finance-minister-schaeuble-euro-crisis-means-eu-structures-must-change-a-840640-2.html

[2] This is for example the position of the French President, Hollande. (http://www.guardian.co.uk/business/2012/may/23/eurozone-crisis-france-germany-divide) and previously of the former Italian government (http://www.reuters.com/article/2011/08/13/us-eurozone-idUSL6E7JD02L20110813). For an updated summary of the debate, see http://www.ft.com/intl/cms/s/0/43fcb7fc-17b0-11e2-9530-00144feabdc0.html#axzz29XkwKHVr

1.1.2 The United States' fiscal union

The most studied fiscal union in the world is probably the US. However, the US fiscal union did not appear over night, but was rather the result of a long process. Henning and Kessler[3] argue that today's fiscal federation builds on three principles: 1**) Fiscal transfers between the central government and the state governments**; 2) **a no-bail out principle for state governments and, as a consequence, for local governments**; and 3) **the implementation of state and sub-national balanced fiscal rules.** These three elements identified by Henning and Kessler can be complemented with some additional features: **a clear distinction of competences between general, state and local government**; **the right for the general government of running substantial fiscal deficits if required**; **a central bank mandate which takes into account the stabilisation of the macroeconomic landscape as a top-level goal**; **and a system of federal own resources based on taxation powers**.

The fiscal transfers (1) are deployed mainly within state-managed federal expenditure programmes[4] on certain policy fields, account for around 30% of state revenues and have no macroeconomic conditionality. In case of macroeconomic shocks, however, the main weight of adjustment relies on federal financing rather than state budget spending. While the state balanced fiscal rules impose expenditure contractions during the recessions (therefore having a pro-cyclical effect) the stabilisation effect is provided by large federal financing, which does not need to follow balanced budgets.[5] It follows that the size of the federal budget has to be significant enough to effectively achieve counter-cyclical stabilisation: the central government spending accounts for 50% to 60% of total public expenditures, and represents 20% to 25% of national GDP.

The balanced fiscal rules (2) considerably vary across states and local authorities, as they were introduced at different points in time following a bottom-up process. According to Henning and Kessler, the emergence of these rules is a consequence of internal electoral pressure rather than a federal requirement for participation in the fiscal union. Fiscal rules were not imposed: states decided autonomously to introduce them. Interestingly, most of the balanced fiscal rules of individual US states apply only to government general funds, which do not fund capital investment but only current expenditure. In other words, according to most state fiscal rules, debt emission is still

[3]Henning, R. C. and M. Kessler (2012).*Fiscal Federalism: U.S. History for Architects of Europe's Fiscal Union.*BruegelEssayes and Lectures Series, Bruxelles, 2012. p.5.
[4]Bordo, M.D, Jonung, L. and A. Markiewicz (2011) Does the Euro need a fiscal union? Some lessons from history. *NBER Working Paper* No. 17380)p.10.
[5]Henning, R. C. and M. Kessler [2012 cf. note 3] p. 23.

authorisedbut only to finance infrastructure and other capital investments.[6] Similar approach, suggested also for the European Union fiscal rules,[7] is known as "golden rule".

The no bail-out principle (3) has a rather complicated history. It is neither a clause in the Constitution nor a legal provision of the US legal framework: the 1840's bail-out rejection was a political decision that challenged the status quo: *"whereas no bailout request had been denied by the federal government prior to 1840 (...) no such request has been granted since".*[8] In other words, a bail out is not forbidden under federal law, but it is a political decision that was not taken until 1840.[9]

Concerning the own resources system, the central government is empowered to impose and collect taxation. As for other elements of the US fiscal union, the power of imposing taxes at central level has evolved over time. The main sources of taxation at federal level are an income tax on individuals and corporations, a payroll revenue on wages, and excises on several categories of goods.[10]

In summary, the US fiscal union is based on political emphasis on no-bail outs, balanced budget rules at national level, fiscal transfers in case of macroeconomic shocks, backed by a federal budget accounting for about 20% of GDP and financed with a system of own resources based on central taxation. An additional important feature of the US fiscal union concerns the role of the Federal Reserve as lender of last resort for the federal government, which in turn becomes lender of last resort for commercial and investment banks.

1.2 Why a fiscal union? A macroeconomic view

In the previous section we discussed an example of fiscal union, the United States. This leads us to the question of whether the EU requires a fiscal union, and how it should be organised. While some commentators argue that the US are neither the only model of fiscal union nor the best designed,[11]**the US fiscal union has nevertheless proven to be resilient and produces a good balance between federal solidarity and state responsibility**; two key principles that lie

[6]Ibid. p.18.
[7] See, for example, http://www.europeanvoice.com/article/imported/golden-rules-for-the-eurozone/74128.aspx
[8]Ibid. p.12.
[9] Only one minor case is registered, the Columbia district in 1995. See Henning, R. C. and M. Kessler [2012 cf. note 3] p.15.
[10]Joint Committee on Taxation (2012) *Overview of the federal tax system as in effect for 2012*.JCX/18/12.
[11]Bordo, M.D, Jonung, L. and A. Markiewicz [2011cfr note 4] p.7; Jean Pisani-Ferry in the introduction to Henning, R. C. and M. Kessler [2012 cf. note 3]

at the heart of every fiscal union and whose implementation is currently heavily debated in the EU.[12]

Concerning the question why Europe needs a fiscal union, two answers are worth investigating. From a macroeconomic point of view, the advantages of a full-fledged fiscal union for countries that have joined a monetary union are twofold: firstly, **a fiscal union contributes substantially to the prevention of endogenous asymmetric macroeconomic, fiscal and banking crises;**[13] secondly **a fiscal union helps to correct asymmetric macroeconomic, fiscal and banking crises.**[14] In other words, a monetary union without a fiscal union may be extremely costly for its members and runs the risk of losing credibility in the long run.

1.2.1 Fiscal unions and correction of macroeconomic and fiscal asymmetric shocks.

According to macroeconomic theory,[15] a fiscal union produces several advantages in the correction of fiscal and asymmetric macroeconomic crises.[16] In case of asymmetric economic shocks (or in case of symmetric shocks impacting on asymmetric structures)[17] countries with structural current account deficits may suffer capital outflows, and therefore be forced to adjust their external balance in order to avoid an uncontrolled increase in unemployment. In a currency union, the adjustment obviously cannot be mitigated by exchange rate variations: the loss of monetary sovereignty is therefore the main cost of participating in a monetary union. These countries will therefore be forced to adjust in terms of labour prices if they do not want to suffer a permanent increase in their unemployment rates. The size of the price adjustment may be extremely high, and may lead to a perverse negative spiral in the domestic

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[12] See: http://diplomatie.belgium.be/fr/Newsroom/actualites/communiques_de_presse/affaires_etrangeres/2012/07/ni_200712_tribune_libre_reynders.jsp

[13] Farhi, E. and I. Werning (2012) Fiscal Unions. *NBER Working Paper* No. 18280

[14] Marzinotto, B., Sapir, A. and G. Wolff (2011) What kind of Fiscal Union? *Bruegel Policy Brief*, Issue 6, November 2011.

[15] The original macroeconomic theory concerning Currency areas was proposed by Mundell in 1961. See Mundell, R. (1961) A Theory of Optimal Currency Areas. *American Economic Review*, Vol. 51 No. 4, September 1961, pp.657-665.

[16] De Grauwe, P. (2007) *Economics of Monetary Union*, Oxford University Press; see also Wyplosz, C. (2006) European Monetary Union: the dark side of a major success. *Economic Policy*, Vol. 21, No. 46.

[17] A symmetric shock may have different effects when the structure of economies and governments is different. For example, a financial crisis hitting a federal country may hit federate units differently, following their budgetary situations and the kind of economies they have. For example, countries whose growth rates depend largely on housing and construction sectors will suffer more than countries relying more on agriculture. Some countries may afford higher spending than others in reaction to the crisis because they had less accumulated stocks of previous debts. That explains why the enduring negative effects of the 2008 crisis differ across EU (and also US) states.

economy.[18] Moreover, fiscal unions provide financial resources to countries in need of adjusting their economies, distributing costs over the whole territory and over time and making adjustment credible.[19]Supporting macroeconomic adjustment with governmental expenditure is essential: and indeed, this is what happened in the intra-Euro macroeconomic adjustment in Germany in the 2000s. Indeed, as demonstrated by Merler and Pisani Ferry,[20] there is no solution to the crisis if the Euro Area does not introduce at least one of these instruments: a common banking guarantee, sovereign fiscal transfers, or the ECB as lender of last resort for banks. Each of these three institutional evolutions has a fiscal nature and requires a taxpayers' backstop:[21] in other words, any solution to the crisis requires a step towards fiscal integration.[22]

1.2.2 *Fiscal unions and prevention of endogenous macroeconomic and fiscal shocks*

A fiscal union is also essential to prevent the emergence of asymmetric and fiscal crises. Correction of macroeconomic imbalances within a monetary union

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[18] This is even truer given limited labour mobility as adjustment channel in Europe and the reversal of capital flows that occurred during the crisis, that showed that capital integration is not an adjustment channel if there are concerns over the survival of the currency. Moreover, capital integration is always limited and does not represent a useful tool to prevent mass unemployment. De Grauwe, P. [2007, cfr. Note 16] p.21 of Italian edition.; Farhi, E. and I. Werning [2012. Cf. note 13] p.3.

For capital integration, economic literature intended that some citizens living in country A hold bonds, shares and bank deposits in Country B, and vice-versa: if an asymmetric crisis hits Country A, reducing its internal output, and increasing output of country B, the decrease in internal demand of country A would be lesser than expected, as the value of the financial activities of Country B held by citizens of Country A will increase generating positive wealth effects; similarly, the increase of demand in Country B would be lesser, because the value of financial activities of Country A held by citizens of country B will decrease, generating negative wealth effects. However, if the crisis endures, citizens of country B will sell their activities in Country A to limit losses, while citizens in Country A will sell their activities to maintain consumption levels. In other words, if there are no credible expectations of crisis-resolution on the short term, financial integration will collapse, denying its effectiveness as a tool of macroeconomic adjustment in case of strong asymmetric crises. Indeed, we observed exactly a collapse of financial integration during the current crisis, as shown by Merler, S. and Pisani-Ferry, J. (2012) Sudden Stops in the Euro Area. *Bruegel Policy Contribution,* Issue No. 6, 2012 ,and by Daniel Gros (2012) Macroeconomic Imbalances in the Euro Area: symptom or cause of the crisis? *Ceps Policy Brief*, No 266, April 2012.

[19]"It is a chief function of fiscal policy, using both sides of the budget, to offset or compensate for regional differences, whether in earned income or in unemployment rates. The large-scale transfer payments built into fiscal systems are interregional, not just interpersonal [...]" Kenen (1969 p.47) cited in Farhi, E. and I. Werning [2012. Cf. note 13] p.2

[20]Merler, S. and Pisani-Ferry, J. (2012) The Euro Crisis and the new impossible trinity.*Bruegel Policy Contribution*, Issue No. 1, January 2012

[21]Pisani-Ferry, and Wolff demonstrate that a banking union without fiscal integration is unthinkable.

Pisani-Ferry, J and G. Wolff (2012) Fiscal implications of a Banking Union.*Bruegel Policy Brief*, Issue No. 02, September 2012.

De Grauwe demonstrates that a central bank as lender of last resort de facto produces fiscal liabilities for its constituencies.

De Grauwe, P. (2011) *The European Central Bank as a lender of last resort.* Contribution to VoxEU.org availableathttp://www.voxeu.org/article/european-central-bank-lender-last-resort

[22] However, this is likely to create moral hazard conditions (As shown by US history before 1840) inducing governments to pursue larger deficits than in normal times. This problem may be addressed in two ways: imposing conditionality on debt guarantees, or substituting debt guarantees with fiscal transfers.

is always a painful process, even if a fiscal union is in place. Therefore, it is necessary to put in place prevention mechanisms that will require a joint fiscal effort of the participating countries. As a matter of prevention, the integration of budgetary frameworks, the creation of a common budget, the introduction and enforcement of supranational fiscal disciple would create a credible and sound fiscal behavior. As a result, the promotion of sound fiscal discipline in normal times will not only prevent the accumulation of excessive debt stocks (making the partners' intervention in crisis times less likely) but will also prevent the emergence of dangerous moral hazard.

In other words, a full-fledged fiscal union may represent a sustainable solution to the Euro crisis. In order to be effective, the European Fiscal Union must include the following elements: a crisis resolution mechanism, that activates conditional fiscal transfers or debt guarantee in order to achieve credible macroeconomic stability in case of shocks without spill-over in a fiscal crisis;[23] abudgetary integration, that prevents the emergence of excessive deficits, introduces fiscal alignment and allows for better policy alignment;[24] and stricter policy cooperation, that prevents the emergence of endogenous asymmetric shocks over time.

1.3 The state of the play: elements of fiscal union already in place or under approval.

While still far from representing a true fiscal union, the MS of the EU and of the Euro Area in particular, can no longer be simply described as countries enjoying full fiscal sovereignty. Aware of the macroeconomic constraints summarised above, the architects of EMU already included in the Treaty of Maastricht some features of a Fiscal Union, albeit weak. These have been reinforced over time both through reforms of the constitutional architecture and ordinary legal procedure. As a result, nowadays fiscal sovereignty has been reduced via two

[23] This pillar may be substituted or completed by a banking union, or providing the ECB a mandate as lender of last resort, in order to break the perverse dynamic between banking and fiscal crises, restoring a market for national bonds and preventing further capital outflows. An important debate emerged on the role of fiscal transfers: if they are permanent, they create a not acceptable moral hazard situation. If they are conditional, the moral hazard is tackled, but there is problem concerning credibility. The proposals in the direction of achieving better budgetary integration and surveillance in normal times are several and will be discussed below. It follows that, in case of asymmetric macroeconomic shocks, an effective fiscal union may either extend a joint debt guarantee, making internal adjustment sustainable via local debt, or preserve a no bail out strategy while providing counter cyclical conditional fiscal transfers.

[24] Chicago economics professor Goolsbee affirmed that a fiscal union composed by the simple budgetary control would be harmful for Europe. See Goolsbee, A. (2012) *A* fiscal union won't fix the Euro crisis. *The Wall Street Journal*, 29 May 2012. Available at: http://online.wsj.com/article/SB10001424052702304707604577428211717125298.html

channels: actual legal provisions and factual spillover effects across countries arising from increased economic interdependence.

In the following part, the current and emerging institutional provisions will be described and structured around the**elements of a fiscal union designed to work "in normal times"** to prevent the emergence of fiscal and macroeconomic shocks (1), and the **elements designed to work in "crisis times"** to facilitate fiscal and macroeconomic adjustment during asymmetric crises (2).

1.3.1 Prevention of fiscal and macroeconomic shocks

Since the Treaty of Maastricht, the most developed element of fiscal union in the EMU was the process towards a sound fiscal policy. Art. 125 of the TFEU establishes an explicit no bail-out clause, that would hypothetically be a strong incentive against moral hazard; art. 126 establishes the principle of avoiding excessive debts and deficits[25] and establishes the first elements of an excessive deficit procedure to ensure MS complying with the treaty provision. The crisis, however, imposed a quick revision of the governance process: two "packages" of legal provisions were proposed by the Commission: the "Six-Pack" (already approved) and the "Two-pack" (still under co-decision procedure), complemented by the new Treaty on Stability, Coordination and Governance (the "Fiscal Compact").

- *The Six Pack.*

1) **The reform of the SGP**. The first new block of legislations and legal provisions is composed of five regulations and one directive. Three of the five regulations aim to strengthen the SGP established in 1997, with regulations 1173/2011, 1175/2011 and 1177/2011[26]. The latest versions of the SGP impose to Euro Area (EA) and the countries participating at the Exchange Rate Mechanism II (ERMII)[27] countries a medium term structural balance objective higher of -1% of GDP. The annual deficits are allowed if they realise an annual positive adjustment towards the country medium term Structural balance[28] objective of at least 0.5% of GDP for countries with debt ratio over 60% of GDP. Moreover, the country debt shall be reduced by 1/20 per year until it reaches a level of 60% of GDP.

[25]Defined in the Protocol to the TFEU on Excessive Deficit Procedure at 60% and 3% respectively.
[26] There is no point to lead an extensive discussion on the effectiveness of the SGP, discussion that, however, shall not be excluded for future work.
[27] ERM II countries are the three non-euro area countries participating in the European Exchange Rate Mechanism: Latvia, Denmark and Lithuania. See for further information: http://ec.europa.eu/economy_finance/euro/adoption/erm2/index_en.htm
[28]Structural balance is defined as the net lending/borrowing of a government adjusted for the cyclical component of the economic performance.

Not complying with supranational fiscal rules may trigger the Excessive Deficit Procedure(EDP) (reg. 1467/07 amended) and results in a set of fines recently defined (reg. 1173/2011). Additional fines may be indirectly imposed towards the suspension of cohesion funds payments (art. 4 re. 1084 2006 and art. 21(6) of the proposal of regulation 2011/0276 COD).

2) **The directive on budgetary frameworks.** The directive 2011/85/EU requires MS to put in place national numerical fiscal rules in order to prevent the EDP and to set up coherent medium term budgetary frameworks.
3) **The European Semester (ES).** To achieve coherent and coordinated economic policy (which are a consistent part of the strategies aiming to prevent asymmetric macroeconomic and fiscal shocks) the TFEU provides a treaty base in art. 121 on macroeconomic coordination, and in art. 148 for employment policy coordination. According to these two articles, the economic policy coordination will be based on the ES, introduced in 2011 within the amended version of reg.1466/97[29]. Under the ES, economic policy coordination is achieved with an ex-ante coordination of the budgetary provisions of member states: in November each year (year X) the Commission proposes a strategic document, the Annual Growth Survey (AGS) to address MS' macroeconomic policy in the fiscal year (X+2).[30] In April of the year (X+1) the MS will submit National Reform Programmes (NRP), specifying how they will intend to address in their next budget the Commission priorities, and Stability Programmes (SP), specifying how their budgets will be coherent with the fiscal provisions of the previous paragraph. In July each year the Council, following the Commission proposal, will deliver country-specific recommendations either on the content of the NRPs in order to achieve better alignment with the AGS, or on the content of the SPs to achieve fiscal targets. After July, MS will have to implement their commitments and the Council recommendations in their annual budgets for the following fiscal year, whose actual content will be coordinated under the forthcoming regulation 0386/2011 referred below.

- *The Fiscal Compact and Two Pack*

1) **The Treaty on Stability, Coordination and Governance** (TSGC). The provisions of the Treaty, still under ratification process, stipulate that participating countries are required to pass annual balanced budgets

[29] For further reference on the European Semester, see Wolff, G., Hellberg, M., Marzinotto, B. Seucheil, P., Nicoli, F., Andreicut, D. L. and Granelli (2012) *An assessment of the European Semester* (forthcoming: the title may change). *Bruegel Report, 2012.*

[30] If the reg. 0386/2011 cited below will be approved, the AGS will be based on the EA budget consolidation done from the Commission each year in October.

(defined as budgets with a structural deficit not exceeding 0.5% of GDP) and to reduce their public debt at pace of 1/20 per year. These norms, however, will not be subject only to the scrutiny of the Commission and the Council, but also of the European Court of Justice (ECJ), which will have the power of imposing additional sanctions. Moreover, any of the contracting parties will have the right of bringing another in front of the ECJ if it considers that the partner is not respecting the treaty provisions.[31] Moreover, theFiscal Compact introduces, under article 13, stricter cooperation among MS' parliaments and the European Parliament concerning Economic Governance: joint committees may be established to discuss budgetary and economic issues.

2) **The regulation 0386/2011**. The provisions of the regulation, still in approval, askMS to put in place national fiscal councils to monitor fiscal policy and require from EA member states to send their annual budgets to the European Commission by 15th of October each year:[32] the Commission will propose recommendations on the individual budgets, which will be voted by the Council and therefore implemented at state level; the Commission will also propose an "overall assessment of the EA budgetary situation" (a preliminary budget consolidation) which will be voted by the Eurogroup.[33]

- *Additional features*

An additional contribution in delivering policy alignment comes from the particular kind of fiscal transfers in place in the EU. Differently from the US, where the fiscal transfers are unconditional, not equalised[34] and play a counter-cyclical role, the fiscal transfers currently in place in Europe are limited, follow an equalisation principle, do not have a counter-cyclical function[35] and are evolving towards increased conditionality.[36] Therefore, even if they represent a

[31]The in-debt analysis of fiscal rules, accompanied by several simulations, carried out by Robertn Inman seems to support this provision: in his results, he demonstrates that no fiscal rule, neither strong nor weak, is effective without a possibility of partners to bring the case before a court ex post control. See Inman,R. (1995) Do Balanced Budget Rules work? US experience and possible lessons for the EMU. *NBER Working Paper* No.5838, p.28.

[32]First of October in the Ferreira report which amends the regulation.

[33] If the amendmentsof the report cited in the previous note will be approved, also by the European Parliament will acquire a similar role.

[34] From a broad perspective, equalisation means that fiscal transfers are deployed asymmetrically over the territory in order to provide the same service: the equal quality of the service is the guiding principle leading allocations; as different countries and regions enjoy different wealth, income and taxes, the size of the central allocations depends on these variables in order to ensure equal service. See, for example, Vaillancourt, F. and R. Bird (2004)*Expenditure based equalisation transfers.* Paper presented to the conference held in Stone Mountain, State of Georgia, 3-5 October 2004,p.3

[35] And there would be no reason to be counter-cyclical, as they refer to the whole EU –not just the Euro Area- and there is no macroeconomic point in centralising counter-cyclical management outside of monetary unions, while it exists a strong point for centralising it within monetary unions.

[36] See, for example, title II, chapter IV (art.21-22) of the proposed reg. no. 2011/0276 COD

key feature of the embryonic European Fiscal Union, their function is to better achieve policy coordination and alignment –and therefore contributing to the prevention of macroeconomic and fiscal imbalances- and not to facilitate macroeconomic and fiscal adjustment. In this regard, it shall be noticed that the EU budget is not only extremely limited in size (around 1% of EU GDP), but-being alimented by state contributions without any possibility of pursuing central deficits, it is also intrinsically pro-cyclical. The current discussions concerning the Multiannual Financial Framework (MFF) 2014-2020 have partly focused on the creation of a system of own resources for the EU, including taxation measures, but the EU countries have not reached a comprehensive agreement on the issue so far. Part of these countries will probably proceed with a strengthened cooperation to establish a financial transaction tax (FTT) replacing their contributions.[37]

Finally, recent regulations (no. 1176/2011 and 1174/2011) introduce an excessive macroeconomic imbalance procedure (EIP) and a system of sanctions. The goal of the EIP is to prevent EA MS to accumulate important macroeconomic imbalances over time (for example, in the external deficit/surplus towards other EA countries). Therefore, an alert scoreboard of indicators has been created: when certain indicators provide an alarm signal, the Commission will carry out in-depth reviews of the concerned economies, eventually addressing recommendations in order to correct those imbalances. Not complying with the recommendations may trigger a specific set of sanctions.

1.3.2 Crisis resolution mechanisms

As shown above, the EU has already a wide set of options and policies to prevent the emergence of fiscal and macroeconomic crises. However, **the real institutional lack of the EU is the crisis resolution mechanisms**. If, despite all the measures in place to prevent crises from happening, an asymmetric crisis hits, a monetary union must pursue a credible adjustment. Credibility is essential: if the adjustment is too costly for some of the states, concerns over the stability of the currency arise and may become self-fulfilling.

TheEU, and the Euro Area in particular, have so far only a limited set of instruments that aim to make structural adjustment compatible with fiscal consolidation. The first, still in discussion, is the ESM. The main role of the European Stability Mechanism(ESM) is to provide financial assistance for EA countries suffering or threatened by severe financial instability, under strict

[37]Dhéret, C., Martinovici, A.And F. Zuleeg (2012) *The State of Play on the EU Multiannual Financial Framework (MFF) 2014-2020interinstitutional negotiations.*EPC report for the Committee of Regions,pp. 29-30.

conditionality.[38] So far, its primary function is to provide conditional support to EA member states that, pursuing in the meantime fiscal consolidation and structural reforms, have entered in a downward dynamic. However, the ESM would potentially be able to negotiate financial support before the beginning of the reforming process, preventing financial instability and making more credible the adjustment process itself. Much will depend on political decisions behind ESM management: too strict conditionality may prevent states to ask ex-ante for financial support, making their eventual failure in pursuing non-founded reform process more costly.

However, the ESM may play a strengthened role in promoting structural reforms. Further financial support may be delivered if the political agreement of 28 June 2012 will have a legal follow-up: in this agreement, EA countries accepted to use the ESM as a support mechanism for reforming countries: intervention on bond market from the ESM will be enabled for countries engaging themselves in applying the Commission recommendations delivered during the ES. If the ESM will effectively work under this principle, it may represent a first form of true conditional fiscal transfer. It shall be noticed, moreover, that being subject to ESM financing produces, as collateral effect, an extension of the cofinancing rates under the reformed Cohesion Policy.[39] If both the political agreement of the 28 June and the new regulation on cohesion policy are realised, complying with Council recommendations delivered under the European Semester will be associated with considerable financial advantages: ESM interventions on the Sovereign Bond market, and Cohesion policy increased cofinancing rates.[40]

A second element of crisis resolution would be a full-fledged banking union, composed of a resolution mechanism, a deposit guarantee scheme and a supervision authority. A banking union, **while not representing a true fiscal union, will require strong fiscal backstop**. However, the current banking union proposals do not refer to any joint deposit guarantee scheme. The current proposal, therefore, cannot be qualified as a component of a fiscal union (as it would have been if it included a joint deposit guarantee scheme) and will be therefore excluded by the already in place (or under discussion) elements of fiscal union.

Following the analysis of the previous pages, table 1 draws a comparison between the US Fiscal Union and the already existing elements of the European embryonic fiscal union.

[38]Treaty Establishing the ESM, art. 3

[39] Art. 22 reg. no. 2011/0276 COD

[40] However, it shall be noticed that the overall lending capacity of the ESM is limited, amounting to less than 10% of the Euro Area debt.

Table 1.1 : comparison between US and Euro Area measures				
Preventionpillar	**US**	**Characteristics**	**EA**	**characteristics**
State budget fiscal rules	Present	Developed individually by each country	Present	Imposed supranationally into the national law by Directive 2011/85/EU. The numerical content is specified in art. 126 TFEU, reg. 1466/97 amended, and art. 3 Fiscal Compact
supranational enforcement of state fiscal rules	Not present	//	Present	Enforced through a political sanction system laid down in art. 216 TFU and specified in reg. 1466/97 amended, 1467/97 amended and 1173/2011. Further sanctions may be delivered as a legal decision under Art.8 Fiscal compact.
Multi-annual fiscal frameworks	Not required	//	Present	Directive 2011/85/EU
No bail out clause	Present	Not legally defined but politically enforced	unclear	Art. 125 TFEU vs ESM provisions
Fiscal transfers with policy aligning functions	Present	Present. They account up to 30% of state budgets. Not conditional, not equalised, with also counter cyclical functions	present	Extremely small, conditional, equalised
- If present, financed with:	Federal taxes; federal deficit		Member states contributions	
Supranational supervision of macroeconomic imbalances	Not present	Not required, as there is no eventuality of emergence of intra-US macroeconomic imbalances	Present	Control and sanction mechanisms under reg. 1174/2011 and 1176/2011. Never tested.
Policy alignment	Present	Large central budget (20% of national GDP). Clear separation of powers, no need of pursue policy alignement in policies of national competence	Partially present	European Semester in reg. 1466/97 amended. Conditional cohesion policy (art. 21-22 reg. 2011/0276 COD).
State budgetary consolidation	Not present	Not required. Clear distinction of functions, central budget sized enough	Not present yet	First steps may appear in reg. 0386/2011
Resolution pillar	**US**	**Characteristics**	**EA**	**characteristics**
Counter-cyclical fiscal transfers	Present	Federal budget overall 20% of GDP. If required the fedral budget may increase	Not present	May be partially introduced and subjected to conditionality if the political agreement on the ESM functions of 28 June 2012 will be effectively realised. Central EU budget 1% of the EU GDP. Need for constitutional agreement to increase it substantially
- If present, financed with	Federal taxes; federal deficit		1% and ESM financed via MSs contributions	
Bail out of states	Not present	//	Present	Despite art. 125 TFEU, the ESM can provide financial assistance under macroeconomic conditionality
Debt mutualisation	Not present	//	Not present	//
Possibility to pursue central deficits	Present	The federal government may raise taxes and emit debt	Not present	EU budget has no true own resources, cannot levy taxes, and shall be in balance
Banking Union	Present	The Government may bail out banks, supervise banks, and has a federal deposit guarantee scheme	Not present yet	ESM would-eventually-be enabled to bail out banks. The ECB will supervise banks. There is no deposit guarantee in discussion yet
Lender of last resort for sovereign	Present	The FED acts as a lender of last resort for the federal government, but not for the state governments	Not present	Forbidden by art.123 TFEU

1.4 A long term vision for a European Fiscal Union

What it is still missing for the completion of the European Fiscal Union? A possible long-term outcome of the ongoing discussions over a fiscal union for Europe could be **a model based on three pillars,** taking proper account of functioning models of fiscal unions as well as European particularities.[41] These three pillars consist of **some degree of fiscal sovereignty for European Institutions** (1**); coordinated budgetary procedures** (2); **and MS' sovereign national budget** (3).Considering that we are studying a long-term outcome, we do not make distinctions between Euro Area and European Union frameworks. These elements are explored in more depth below.

The first pillar**concerns European Institutions acquiring some degree of fiscal sovereignty**. **Fiscal sovereignty implies three elements; power of raising taxes** (1**), power of pursuing discretional spending** (2), **and power of running budgetary deficits if required to counter-balance the pro-cyclical developments at national level**[42] (3). In this context, cohesion funds shall be maintained but will only represent one of the automatic vehicles of fiscal transfers. Regional policy shall also be directly discussed with regional authorities, without the mediation of national states that are nowadays held accountable at the EU level. This would imply to rethink the macroeconomic conditionality that is currently under discussions. In order to overcome the incoherence of penalising regions due to the bad macroeconomic position of MS, cohesion policy could be conditional to regional performance scores, and not to central government macroeconomic decisions.

In addition, the discretionary vehicle of spending shall be backed by a power of raising EU taxes and generating 'real' own resources and by a power of issuing Union Bonds. The EU level budgetary dispositions shall be subject to democratic scrutiny at EU level through the process of EP elections, with

[41] Other proposals concerning fiscal integration are partially converging with the first pillar of our proposal: see, for example, the Padoa-Schioppa report on fiscal union. Enderlein, H, Bofinger, P, Boone, L. De Grauwe, P., Piris, J.C., Psiani-Ferry, J., Rodrigues, M.J., Sapir, A. and A. Vitorino (2012) *Completing the Euro: towards a fiscal uion in Europe.*Report of the TommasoPadoa-Schioppa Group, Notre Europe.

[42] Molino and Zuleeg share the idea that the EU budget shall have a counter-cyclical role. CfMolino, E. and F. Zuleeg (2011) *The EU budget in a era of austerity: setting the example or compensating for national cuts?*EPC workshop Document, Turin, 2011.
Majocchi also shares a similar position concerning the growth of the Union balance-sheet: without an explicit reference to pursue fiscal deficits, the author promotes the idea that the Union budget shall be substantially increased, with new competences including developments of sustainable economy (while sustainable refers also to economic stability) and financed with own resources. See Majocchi, A. (2012) Dal Fiscal Compact all'Unione fiscale. In Bovicini, G. And F. Brugnoli (eds) Il Fiscal Compact. *Quaderni IAI*, pp.45-52

governments accountable to its majority in the Parliament for discretionary expenditures.

The second pillar is the coordinated budgetary procedure. The joint budgetary procedure proposed here is heavily based on institutional settings already in place or in discussion, that shall be integrated and completed with other elements (already on the table or proposed by independent research institutions). Integrating these elements properly will create a powerful tool for fiscal integration.

Under this procedure, **MS will maintain their policy competences on areas with shared competence but they will integrate their budgets**: at the end of each budgetary process, **a European budget will be produced integrating draft national budgets.**MS will scrutiny each other in the process, elaborating if required common policies; the financial coverage will be based on national resources but agreed with the partners; a finance minister of the EU will be enabled to veto on national final budgets.[43]**Emission of national debt will be agreed with the partners:** the debt will be serviced individually by countries **but it will be object of joint guarantee.** The split up of the two procedures (sovereign budget and joint budgetary procedure) might also be implemented with the creation of two categories of debt assets: similarly the re-blue bond proposal,[44]**the blue bond category of asset will be emitted by individual member states to finance *new* expenditures agreed within the joint budgetary procedure**; it will be backed by joint guarantee and will be senior on other state bonds. MS will of course be enabled to emit their own sovereign state bonds to finance individual budget, **but these red bonds will not be backed by joint guarantee and will be junior in respect to Union bonds and blue bonds**. Democratic legitimacy for the process may also be achieved **by joint committees of National Parliaments and the EP** to discuss common budgetary provisions, as already envisaged in art. 13. of the Fiscal Compact.

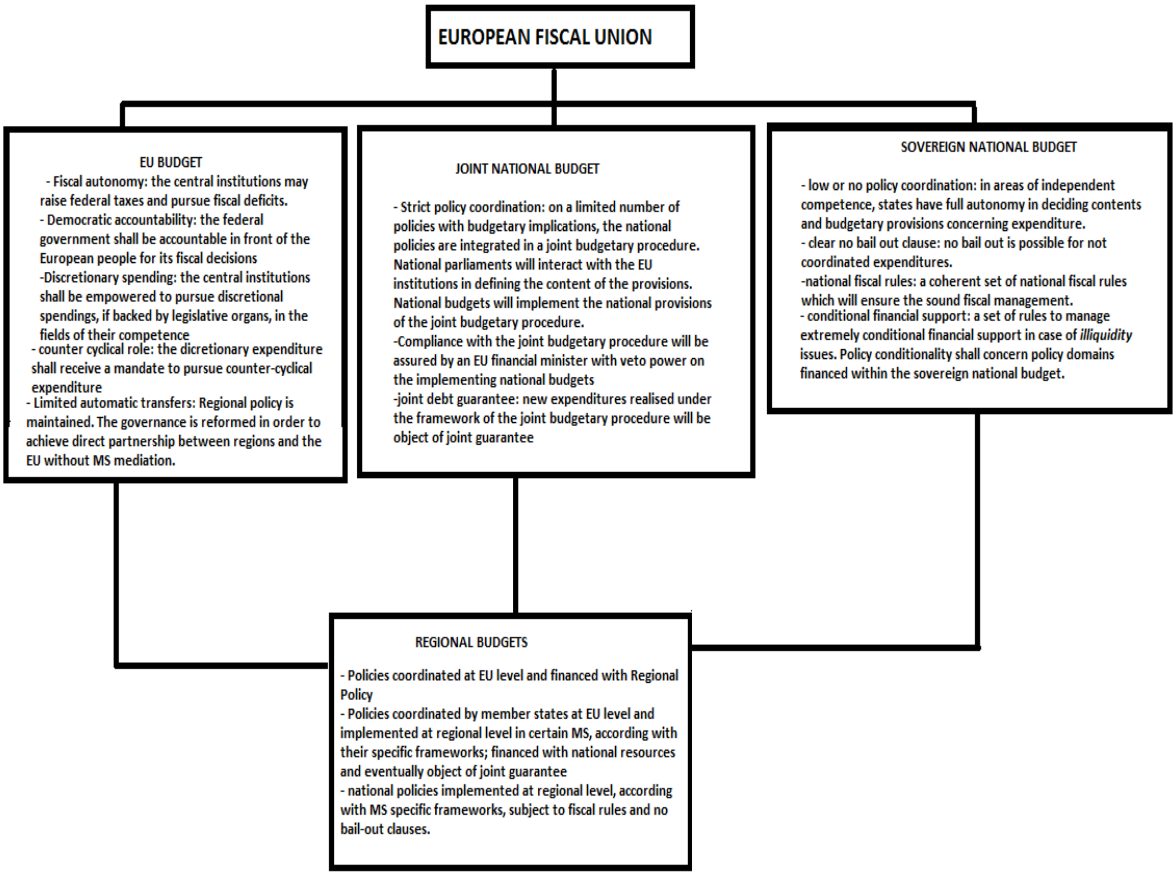
The third pillar is the sovereign national budget of each MS. Sovereign national budgets will be completely autonomous, financed with national resources and national deficits, without any joint guarantee. National

[43]Marzinotto, B., Sapir, A. and G. Wolff [2011 cf. note 14] advanced a similar proposal, which was followed by several endorsements from ministers of different Euro Area government, for example W. Schaüble [cf. note 1]
[44] The blue-red bond proposal was advanced by Deplaans Von Weizsäker in 2010. The core idea is to create a mechanism of sharing of accumulated stocks of debts: the countries would merge together the parts of their debt stocks up to 60% of their GDP: this share would enjoy a mutual guarantee and being senior in respect to red bonds. Red bonds are emitted to finance the left part of the debt stocks, would not enjoy mutual guarantee and would be junior. In our proposal here we do not advance mutualisation of previous stocks of debt, but we apply the blue-red model to *new* expenditures produced in the framework of the Joint Budgetary Procedure and the one of the traditional national budgets. See Depla, J. and J. Von Weizsäker (2010), *The Blue Bond proposal*,Bruegel Policy Brief, Issue2010/03; Depla, J. and J. Von Weizsäker (2011) *Eurobonds: the Blue Bonds concept and its implications,* Bruegel Policy Contributions,Issue 2011/02.

governments will be individually accountable for their sovereign budgets in front of their constituencies, and a credible no bail-out rule shall be established. In case of illiquidity problems, the ESM (or their successors) will provide limited, temporary and strictly conditional financial support, only in MS with internal fiscal rules on place. The national budgets will be prepared in accordance with the national fiscal rules, the “old” debt and deficit ceilings agreed in the SGP (that may eventually be slightly relaxed given the stronger coordination achieved) and will issue junior red bonds to finance fiscal deficits.
Figure 1.1 summarises the model of long term fiscal union we will adopt in this note.

In normal times, the discretionary expenditure from the EU budget will be rather contained and- following the core democratic assumption on sovereignty of people on fiscal issues-backed by taxation measures under the control of a Parliament. The joint budgetary procedure will assure better spending policies and policy alignment, together with coordinated control over the main chapters of national expenditures, preventing the emergence of macroeconomic and fiscal disequilibria. Finally, the states will retain strong fiscal sovereignty on their individual sovereign budgets, but the implementation of the fiscal rules, the clear no-bail out clause and the junior status of domestic bonds will prevent the emergence of worrying endogenous fiscal disequilibria. Concerning the prevention of macroeconomic disequilibria, the already existing macroeconomic imbalances procedure, together with the discretionality of the Union budget, the joint banking supervision, and the strengthen policy and budgetary coordination under the joint budgetary procedure will be enough to protect the union from inter-state endogenous imbalances.

Figure 1.1: a model of fiscal union for Europe



Source: authors' elaboration

However, fiscal crises and macroeconomic imbalances may arise as a result of exogenous effects, where internal coordination in a fiscal union can do little to prevent. A fiscal union like the one we are discussing will nevertheless have considerable chances to overcome exogenous shocks, both symmetric and asymmetric. On the state level, the fiscal rules and the market pressure will oblige governments to contain sovereign budget expenditures producing a pro-cyclical effect (as assessed in the US) that will reduce the deficit while worsening the recession; the joint budgetary procedure, however, will ensure a better spending of the remaining spending chapters, together with the guarantee on its sustainability. The overall effect, therefore, will be a relative increase in the share of the sustainable debt stock of the MS, together with a better value of money. Finally, the Union budget will play its real counter-balancing role in case of external shocks: it will shift discretionary expenditure in case of asymmetric shock, or will produce temporary deficits in case of symmetric shocks, off-setting the pro-cyclical effect of national budget restrictions preventing the emergence of a perverse spiral, therefore ensuring effectiveness of national deficit reduction programmes.

In case of assessed illiquidity problems on national budgets, the ESM (or its successors) will provide conditional financial protection; in case of banking crises, finally, the banking union (not discussed here but assumed as in force on the long run) will deal with eventual banking failures, backed by the ECB or by the Union discretionary budget**.**

PART 2: The implications of a European Fiscal Union for LRAs

2.1 The overall impact of fiscal governance on LRAs before the crisis

If the discussions on how to complete the European fiscal governance have characterised the last years of the crisis, **the introduction of coordinated fiscal provisions is not new for the EU** and the development of fiscal governance has been a **long lasting process that started well before the crisis**. As already mentioned, the 1997 SGP already imposed a control on deficits, a set of procedures to deliver corrections and to ensure MS'compliance with the overarching budgetary deficit and public debt targets and introduced the possibility of sanctions.[45] Since the very beginning of the process of monetary integration, European leaderships were aware of the need of progressive fiscal integration.[46] The idea that monetary integration implies fiscal integration is therefore having political foundations for a long time as illustrated by the famous statement that Romano Prodi gave at the Financial Times on 4 December 2001 saying that: '*I am sure the euro will oblige us to introduce a new set of economic policy instruments. It is politically impossible to propose that now. But some day there will be a crisis and new instruments will be created'*[47].However and in spite of policy-makers' acknowledgement of the need for deepening European fiscal integration, this latter has always faced political opposition in some MS such as Germany and has been mainly driven by macroeconomic considerations rather than a shared political vision.

In this context, **the creation of a set of fiscal provisions within MS is a process that has continued alongside, and on the impulse of, the attempts of fiscal coordination at European level**. Arguably, internal forms of cooperation between the national and subnational levels as well as stronger budgetary discipline at the subnational level were necessary to avoid the emergence of a free rider dilemma[48], as the sub-national public sector forms a part of public

[45] See Art.11, Section 4 of the SGP: 'Whenever the Council decides to apply sanctions to a participating Member State in accordance with the Article 104c (11), a non-interest-bearing deposit shall, as a rule, be required'.
The original SGP, however, has been ineffective to achieve its goals: the sanction mechanism, for example, gave the role of the regulator to the same countries eventually object of sanctions. Already in the first 2000s, emerged some doubts on the real capacity of the SGP to deal with large asymmetric macroeconomic shocks. Balassone, F., Franco, D. and S. Zotteri (2003) Fiscal Rules for Subnational Governments in the EMU context. *SocietáItaliana di EconomiaPublica,* Working paper No. 196/2003, p.5.
46 See, for example, the Werner report . Werner, P. (1970),*Report to the Council and the Commission on the realization by stages of economic and monetary union in the Community*. European Communities, Brussels.
[47] Striking, at this regard, is the famous statement of Romano Prodi at the Financial Times, on 4 December 2001: "I am sure the euro will oblige us to introduce a new set of economic policy instruments. It is politically impossible to propose that now. But some day there will be a crisis and new instruments will be created."
[48]Balassone*et al.* [2003 cfr. note 45] p.7.

debt. They were thus **progressively introduced even if they were not directly required by the original SGP** as EMU documents did not specifically address the role of sub-national government in achieving the national targets imposed by the EU.

In some states, internal budgetary provisions were developed as a direct effect of the introduction of the first version of the SGP and mimicking the rules adopted at the European level. However, it is important to underline that **the adoption of rules in order to adapt to the new European environment has taken different forms and reflects to some extent the diversity of institutional settings** across the EU. For instance, countries like Austria, Belgium, Italy, and Spain have introduced explicit 'domestic pact' despite different characteristics and scope[49], while other countries such as Estonia, Portugal, the Czech Republic, Italy, Slovakia, Poland, Spain etc. have also implemented some measures to control subnational debt developments.[50]

Moreover, the **system of financing sub-national governments** has also been reformed in a lot of EU countries over the last decades and might be a **direct consequence of both a general decentralisation process[51]taking place in Europe and the Europeanisation of fiscal policy**. While in some states such as Germany, Belgium, Austria, Italy and Poland, the constitutions already provided provisions on the sources of financing of subnational governmentsand recognised their financial autonomy, other countries like France, Bulgaria Austria, Denmark, Portugal, Romania, Slovakia and Spain further modified the financing system of subnational governments.[52]

In addition, in most countries there were fiscal audit councils controlling the local expenditures prior to 2008,[53] and several others had in place "golden rules" allowing flexibility of balance budget requirements for investment expenditure. Some countries, moreover, had sanction systems (financial or administrative) to promote subnational governments alignment with internal dispositions (for example Austria, Belgium, Ireland, Italy and Spain).[54] The table 2.1 reproduces the main fiscal framework provisions of the EU 27 prior to 2008.

[49] See Balassone, F, Franco, D. and S. Zotteri [2003, cf. note 45]
[50] See Hoorens, D., Chatrie, I., Cohen, P., Grau, S., and H. Hermenier (2008)*Sub-National Governments in the European Union.*DexiaCrédit Local Research Department.p.136.
[51] The decentralisation of finances has developed along with the decentralization of responsabilities. Ibid. p.90.
[52] Ibid. 118
[53] See country factsheets provided by Dexia [2008, cf. note 50].
[54]Ter-Minassian, T. (2007) fiscal rules for subnational governments: can they promote fiscal discipline? *OECD Journal on Budgeting*, Vol.6, No.7, p.9

Table 2.1 : overview of national fiscal rules before 2008		
	domestic stability pact	**Other features**
Austria	Yes, introduced in 2002 and reformed in 2005	Financial sanctions for not-complying governments
Belgium	no	Golden rule concerning investments. Administrative sanctions for governments with uncontrolled expenditures
Bulgaria	No	Prudential fiscal rules
Cyprus	No	Local borrowing shall be authorized by central government
Czech republic	Yes, since 2004	
Denmark	Yes, since 2003/20054	Regions cannot borrow as a norm
Estonia	No	Presidential fiscal rules
Finland	No	Municipalities shall meet a balance budget
France	No	Borrowing allowed only for capital expenditure and is submitted to a posteriori legal control
Germany	Yes, since 2003	The federalism reform of 2006 shares the burden of the European SGP between government tiers
Greece	No	Local borrowing in foreign currency shall be authorized by the ministry of finance
Hungary	No	Prudential rules
Ireland	No	Limited spending autonomy of regional level. Any spending decision is centralized. Local authorities can finance capital expenditure agreed with borrowing from central government. There is a set of prudential rules. Administrative sanctions
Italy	Yes , since 1999	Internal stability pact threshold may be modified each year by financial law. Administrative sanctions for not complying governments. Formal no bail out clause.
Latvia	No	Golden rules concerning capital expenditure. No other borrowing. Capital expenditure borrowing shall be approved.
Lithuania	No	Prudential rules
Luxembourg	no	Quantitative thresholds to borrowing
Malta	No	Few prudential rules. Limited fiscal decentralization reduces borrowing needs
Netherlands	No	Political agreements; budget balance requirement excluding capital expenditure
Poland	No	Rules limiting borrowing; prudential rules
Portugal	No	The state may impose fiscal limits to regions within their annual budgets. Law limits to borrowing.
Romania	No	Borrowing shall be approved by a committee
Slovakia	No	Prudential fiscal rules
Slovenia	no	Prudential ratios
Spain	Yes, since 2005	Additional Prudential fiscal rules. Administrative sanctions for non-complying governments.
Sweden	Yes	Strong fiscal rules
United Kingdom	No	Prudential code (excluding Northern Ireland)

Source: Dexia report; Balassone et al. (2003) ; Ter-Minissian (2007)

2.2 The possible future of LRAs under a strengthened fiscal union

The crisisdramatically underlined the shortcomings of the previous fiscal coordination arrangements, producing a swift shift towards a reinforcement of old measures and introduction of new ones, as described at the end of the first section. **The crisis has thus accelerated the move towards a more complete fiscal union and a more centralized control over national budgets and banks**.

Effects on sub-national governance of the new or envisaged measures may be direct or indirect. This section analyses the effects of the EU measures that have been already implemented or are still under negotiations.

Six Pack

The clearest effects on regional governance are produced by the Council directive on ‘requirement for budgetary frameworks of the Member States’[55]. The directive imposes three main obligations to MS: to introduce multi-annual fiscal planning, to introduce independent fiscal councils, and to introduce numerical fiscal rules which shall translate in national law the EU provisions concerning budget. The main provisions of this Directive produce substantial, even if indirect, impacts on regional fiscal governance. The introduction of multi-annual budgetary and financial planning for the general government imposes on LRAs a shift towards multi-annual planning as well, in order to develop integrated general government multiannual planning. The effects, of course, are likely to be different according to MS’ internal organisation: in federal states and in states where regions set taxes and expenditures independently, the effect will result in a true multiannual planning of regional fiscal perspectives, influencing from the beginning of each multiannual term the policy design at regional level. While some countries had already in place multiannual budgeting, some of them will still have to modify their national practices, making the multiannual budget binding[56], or introducing it *ex novo.*[57]

Similarly, the introduction of domestic numerical fiscal rules implementing and enforcing medium term budgeting is supposed to have an indirect effecton the relations between central governments and LRAs. As assessed before, the

[55]Council Directive 2011/85/EU.

[56] This is for example the case of Italy where the provisions of the multi-annual budget or the forecasts on which it is based change each year, or Hungary, where the multi-annual budgeting was only indicative before 2011., and in Belgium, where the federal institutional setting will require a more binding mechanism for sub-national governments.

[57]This is, for example, the case of Portugal. Tournemire, G. *eds.* (2012)Fiscal Frameworks cross Member States: Commission Services’ Country fiches from the 2011 EPC review. *European Economy Occasional Papers*, No. 91, February 2012, p.54-59

obligations apply to the central government and not to regional governments, even if EMU documents refer to the general government fiscal perspectives. It creates a situation where the central government may be responsible for not complying with European legislation, while responsibility rests in fact with regional governments. The result would be an increase in contractual power of regions with some degree of autonomy in determining budgetary perspectives, for example in federal states like Germany and Belgium, and in regional states like Italy. Moreover, the Directive is designed to avoid moral hazard as it specifies that multiannual fiscal planning, fiscal rules and transparency requirements shall be coordinated with all the relevant tiers of government to achieve a comprehensive and consistent coverage of public finances. Therefore, as indicated by article 24 of the Directive, '*the role of (...) subnational governments in ensuring that the SGP is complied with has thereby increased considerably'*. In other words, **the introduction of multi-annual planning at sub-national level, together with the required imposition of numerical fiscal rules effective for regional governments and duly enforced, will considerably increase the formal responsibilities of regional and local governments in fiscal planning, either directly with the introduction of reinforced internal pacts, or indirectly, with the introduction of strong coordination across government's tiers.**

The Fiscal compact and the numerical rules reinforced with the new version of the SGP have a similar effect on LRAs.

TSCG

The TSGC, as explained in section 1, presents two measures with an impact for sub-state governments. The first provision, i.e. the general government structural budget balance, reinforces obviously the provisions of the SGP and requires even more coordination across governments' tiers. A positive structural balance for the general government implies that regional negative balances shall be offset either from other regional balances, or from the general government.

The second provision of the TSCG that may have an influence on the regional governance is the direct competence of the European Court of Justice on delivering sanctions for not complying countries. The overall effect on the regional governance, therefore, is dual: on the one hand, regional autonomy is restricted as regions are forced to cooperate among them and with the central government to achieve European structural balance targets; on the other hand, the participation of the regions is essential for central governments, which might therefore be more willing to accommodate regional claims to obtain fiscal compliance.

Reform of the SGP

As a part of the SGP, the 2011 reform also introduces the ES, which may have an important impact on regional governance. Considered independently the ES will require two contributions from regions -again, the impact is differentiated following internal constitutional organisation. For all MS, the ES will require the regions to report, during the first 4 months of each year, their improvements in term of setting up programmes under EU cohesion policy. Moreover, in the federal or regional countries where the regions hold some degree of financial autonomy and substantial policy design powers, the regions are already required to actively contribute to drafting national reform programmes and stability programmes. Moreover, the recommendations delivered by the Council following the Commission proposal may concern regional level: the recommendations, in fact, may be provided on a broad set of policies: fiscal policy (under SGP and art. 126 of the Treaty); economic policy (art. 121 of the Treaty) labour policy (art.138 of the Treaty) and Europe 2020 Headline targets (Europe2020 Integrated Guidelines)[58].

The impact of the process of budget coordination on regional level, however, would be even increased after the approval of the Two Pack. The first regulation of the legislative block[59] extends the goals of budgetary coordination. If, under the European Semester, the coordination concerned only the design of the policies, in the reg. 0386/2011 it will impact on actual budgetary implementation. MS will be required to submit their draft budgets to the Commission by the 15 of October each year[60] for analysis and recommendations. The time window between mid- July (delivering of Council recommendations) and October (delivering of the draft budgetary laws) is limited. Of course, the draft budgetary laws are not formally discussed with the parliament at that stage;[61] however, the information required by the legislation concerns general government:[62] coordination with regional level is consequently not possible to avoid. Where the regions have limited competences and financial responsibilities, the process would be intuitively easier; however, in federal states and in states with regions enjoying fiscal autonomy the reg.0386/2011 will require intense budgetary coordination among the two levels of government. The process is likely to impact on the regional budget cycles: some regions will

[58] The Europe 2020 Integrated Guidelines are composed by a Council decision concerning employment policy, and a Council Communication concerning Broad economic Policy Guidelines. See Council Decision of 21 October 2010 on Guidelines for Employment Policies in the Member states (2010/707/EU) and
Council Recommendation of 13 July 2010 on broad guidelines for the economic policies of the Member States and of the Union (2010/410/EU)

[59]Reg. 0386/2011/COD

[60] 1st of October in the Ferreira Report of the EP amending the proposal of regulation amendment No. 48

[61] Wolff, G., Hellberg, M., Marzinotto, B. Seucheil, P., Nicoli, F., Andreicut, D. and L. Granelli [2012, cf. note 29] p.99

[62]Art.5 of the regulation.

have to anticipate their budgetary discussions in order to achieve an agreement before discussing with the government. Different cases may arise: in France, for example, regional budgets are heavily dependent on central transfers, which are already included in the annual state budget; any modification on central budget cycles will have only marginal impacts on regional autonomy. In Belgium, the regions have considerable budget powers and usually approve their budgets at the end of each year: requiring general government draft budgets for the first of October will produce a substantial shift in budgetary practice.[63] In Italy, the deadlines for the approval of the budgets may change between different regions; the impact may therefore more pronounced on regions that approve their budgets lately (as Emilia Romagna, usually between November and December) than in regions that approve their budgets early (like Piemonte, usually by the 30 of September). Germany, on the other side, represents a case of federal state where –even if the landers enjoy large fiscal autonomy- the financial sources of the regions are object of negotiation within the Financial Planning Council, composed by the Federal and the Landers' financial ministries, and the federal ministries of labour and economics.[64] As a result, the great part of the budgetary process for landers is already coordinated at federal system, resulting in a less pronounced effect of the two-pack on regional autonomy.

The second legislation of the Two-pack also produces some limited effects on regional governance. If states require macroeconomic assistance under the ESM, or if they are threatened in their financial stability and the Commission decides therefore to apply precautionary financing with the ESM, the MS will be required to produce macroeconomic adjustment programmes in agreement with the ECB, the Commission and- if applicable-the IMF. For the regional level, it would likely imply a loss of autonomy to pursue independent policies-where it is applicable given the internal constitutions of MS. However, one shall notice that the actual autonomy of regions of MS suffering financial distress is likely to already be extremely limited: central governments will do everything to deal with financial instability before considering ESM financing, including restrict spending autonomy of the regional levels as much as possible. Against this background, the entrance of a third category of agents in the decisional process – the EU actors- could eventually even reinforce the autonomy of the regional actors-in comparison, of course, with financial distress without EU intervention. In other words, the impact of the macroeconomic adjustment programmes on regional level may depend on the attitude of the EU level institutions towards the respect of regional autonomy.

[63]Dhéret, C., Martinovici, A. and F. Zuleeg (2012) *Creating Synergies between European National and Subnational budgets.*EPC Report for the Committee of the Regions,p.25.
[64]Lübke, A. (2005) Fiscal Discipline between levels of government in Germany.*OECD Journal on budgeting,* Vol. 5, No. 2, p.28-29.

Finally, we shall take into account the effects of the proposed legislation concerning the cohesion policy for the years 2014-2020. One of them seems to be particularly relevant for their effects on sub-national levels: the macroeconomic conditionality.

Applying macroeconomic conditionality to the distribution of EU funds seems to be an instrument which addresses macroeconomic problems in a wrong way. As explained in the first section of this report, one of the goals of a fiscal union for Europe is to prevent the emergence of asymmetric fiscal and macroeconomic shocks. From this point of view, macroeconomic conditionality is meaningful. However, it creates the wrong system of incentives and penalties: regional governments will in fact directly suffer for decisions that they can only marginally influence. Again, the effect is likely to be different across MS: in certain states, especially in federal states where a federal chamber usually votes the central budget, the inconsistency of the macroeconomic conditionality as proposed by the Commission may be much less developed; while in centralised states, where regions have no responsibilities on macroeconomic choices of the central governments nor can approve or disapprove central government budgetary provisions, the effect of macroeconomic conditionality would be really unfair.

2.3Potential consequences of a full-fledged fiscal union on LRAs

As assessed in the first part of the report, a full-fledged fiscal union may produce substantial advantages in terms of financial stability, fiscal soundness and growth impulse and may also create opportunities for LRAs. However, important risks may also arise.

Concerning the positive effects of the fiscal union on LRAs, we will consider the potential impact of a three-pillar fiscal unionpresented in section 1.4. Naturally, any consideration on these effects is purely speculative, as similar fiscal unions do not exist elsewhere in the world, and the extreme variety of internal territorial arrangements within European nation states makes any comparative analysis with other experiences pointless.

In the model, the European Budget (first pillar) would continue to provide traditional regional policy funding to the regions. However, the fundingshall be conditional to regional performance and not to state performance. This change would significantly increase the responsibility of regions as transfers provided by the EU shall be conditional to the actions and the results of policies implemented by the regions. Moreover, the discretional spending powers managed at central level may produce massive investment flows in regions in need: the specific counter-cyclical characterisation of the discretional spending powers entitled to the central government of the EU will be probably more effective and legitimised if they target regions in trouble, instead of MS in trouble.

The joint budgetary procedure (second pillar) may also have an impact on regional level. Certain MS (depending ontheir constitutional provisions) may have to enable the regional level to implement part of the decisions agreed at supranational level. Of course, in the MS where regions hold similar powers in certain domains, the draft budget submitted within the joint budgetary procedure will already be the result of the negotiation affected by each MS balance-of-powers between regions and central government.

Thirdly, accordingly with their national constitutions, the sovereign budget of MS (third pillar) may contain policies, expenditures, and provisions implemented at regional levels, agreed in cooperation with the regional level, or delegated to the regional level. One shall notice, however, that the functions financed under the third pillar may be probably subject to some additional constraint: the lower guarantee on the debt potentially emitted to finance may create a strong market pressure for balanced budgets, limiting expenditure growth also at regional level. Overall, a full-fledged fiscal union seems to produce a shift in financial relations between government tiers: financing streams from national governments to regional governments will be more constrained and subject to the economic cycle (being fiscal rules inherently pro-cyclical). In the meantime, the partnership between the EU and the regions will be reinforced, especially in times of economic slowdown (when national spending decreases and EU spending increases).

One shall notice, however, that the positive features described above need to be carefully considered: firstly, they do not belong to *any* model of fiscal union, but to the model presented in this work; different models may present totally different outcomes. Secondly, they require full implementation of the project and a strong involvement of the different tiers of governance, including the subnational level. This long lasting process may take several years andits successheavily depends on the political will of national leaders.

Indeed, the main long term risk of fiscal integration for LRAs may arise as a consequence of wrong design or incomplete fiscal unions. In other words, a badly designedfiscal union may produce significant distortive results. Some of them are already visible now, although the EU is still far away from the implementation of a full-fledged fiscal union. For instance, if themacroeconomic conditionality included in the draft legislation of the next Cohesion Policy is implemented, it could have a very negative impact on regions. Therefore, the positive effects that conditionality is supposed to have, namely encouragingpolicy alignment and good performance, willdisappear and may even become negative.

A second major risk that may arise is a spread of reporting requirements, controls made by the institutions, and the multiplication of administrative costs for EU institutions and regional authorities. While ensuring good practices in spending public money is a fundamental principle, flexibility is also an assetand allows LRAs to get financing where it is most needed. At a time when regions call for a simplification of procedures to access EU funds, creating excessive administrative burden would be inappropriate.

Flexibility is also a condition to deal with the incredibly different social, economic and territorial structures of European LRAs: excessive centralisation may represent a real risk, creatingcentralised policies unable to respond to a significant number of territorial particularities. In this regard, it is really essential that a full-fledged fiscal union respectsthe principle of subsidiarity and allows LRAs to implement place-based policies. Overall, the creation of a European Fiscal Union represents a major reform for all the governance tiers of the states involved. Although it requires significant efforts and changes, it can also be a good occasion to increase the effectiveness of the subsidiarity principle, moving competences and finances where they are most needed.

Conclusions

The long analysis carried out in this report provides several insights into the different implications that a European Fiscal Union could have for LRAs.

Based on the analysis of the US fiscal union, the first section of the report has shown that significant elements of a full-fledged fiscal union are still missing in the fiscal setting of the EU, even if recent measures represent a substantial step towards a future fiscal union. In particular, our analysis shows that the current and envisaged regulative frame as well as most important proposals discussed in the last years seem to build up only the second pillar of a proper fiscal union.

In the second section, the authors focus their analysis on the impact of the existing (and expected) measures of fiscal cooperation on LRAs and sheds light on the implications of a full-fledged European Fiscal Union for the regional level and its interaction with the EU institutions.

The analysis concerning the impact of existing measures produces a set of appreciable findings and results, that can be clustered around seven headlinefindings:

1) The introduction of a coordinated process of fiscal governance has been a long-lasting process that has been accelerated by the economic and financial crisis.
2) As a consequence, the process of setting rules for budgetary discipline within MS emerged alongside, and occasionally, following the input of European policies, which have therefore a role in their emergence but cannot be considered as the only cause.
3) The process of fiscal governance seems to proceed into two directions: from one side, onehave observed a process of fiscal decentralisationover the last decades accompanied by the devolution of budgetary powers to sub-national governments; on the other side there is an obvious tendency towards the Europeanisation of overall fiscal policy, especially in countries participating in the EMU and-in a minor share- for the ERMII countries. Also, the main constraints arising from the emergence of a fiscal union depend on central governments, not on LRAs.
4) The recent measures in terms of centralisation of fiscal decisions at EU level seem to have a twofold effect on LRAs: on the one hand, they restrict their autonomy; on the other hand, they contribute to increase regions' bargaining powers *vis á vis*their respective central states. The directive on common budgetary frameworks addresses directly the problem of Moral Hazard as it will increase the responsibilities of the regional authorities: their role in contributing to fiscal policy is formally acknowledged at the European level.

5) Recent and envisaged measures will have direct and indirect effects on sub-national governance. As regards the direct effects,the alignment of regional budget cycles with European rules and the shift towards multiannual budgetary planning have been already observed in several MS.
6) A lot of effects of the measures recently adopted remain to be seen. However, the authors of this note argue that the more autonomy a region enjoys within its national constitutional framework, the more likely the new European governance will affect its powers and decision making process.
7) And finally, it should be underlined that the current literature provides very few information on the role of LRAs in a full-fledged fiscal union. As a consequence, the answer to this question very much depends on how a European fiscal union will be shaped. A Fiscal Union based on the model suggested by the authors would both raise opportunities and challenges for European Institutions and LRAs.

Based on the findings highlighted above, this note lists a set of recommendations that would shape the foundations of a good cooperation between the subnational and the European level in a European Fiscal Union:

1) The report provides solid arguments in favour of a properly designed fiscal union for the Euro Area and the European Union as a whole. Both outcomes in terms of coordination and growth seem to be positive if a fiscal union is well implemented. However, one shall be aware that a European fiscal union, if not properly designed, may entail risks for LRAs. To overcome these risks, a European fiscal union will have to respect the subsidiarity principle and make sure that enough flexibility is provided for implementing policies that are appropriate to local needs.
2) Under a full-fledged fiscal union, there is an increased need for involving LRAs in the design of policies and disseminating information on EU priorities to LRAs in order to ensure better coordination of policies.
3) An important part of positive aspects of a fiscal union arise from counter-cyclical and investment powers accorded to the center. In order to be effective, a full-fledged fiscal union shall be empowered, in the long term, with an EU budget with discretionary spending and investment powers. Given the increase in budgetary surveillance and the consequent constraints MS and regions, in particular the ones most affected by the crisis, will have to face for carrying out long-term investment, EU funds will have a stronger role to play to help these MS and regions exit the economic crisis.

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