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The Path to Fiscal Union: Is This a Feasible Option for the European Union?

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Although the European Union (EU) has been a prominent regional body since the emergence of the Economic Communities in 1951, the European integration project is still underway. The EU has expanded significantly since its initial years, including geographical enlargements, the creation of new institutions and various institutional reforms, and improved competency in multiple policy areas, but it has not yet achieved the full political and economic union which was once the end goal. Currently, the exact direction of the EU is somewhat unclear. What originally started out as an economic institution with the goal of further integration to possibly create a "Federation of Europe" or a "United States of Europe" has now developed into something which has the characteristics of both a regional organization and a federation. This mix of supranational and intergovernmental characteristics has added additional complications to certain elements of the EU, particularly with regard to fiscal policy.

Fiscal policy primarily concerns the level and composition of government expenditure and revenue, budget deficits, and government debt, which is largely managed through government spending and taxes at the federal level (European Central Bank, 2019). According to the European Central Bank (2019), fiscal policy which promotes fiscal discipline and macroeconomic stability is particularly important in the Eurozone, consisting of the 19 EU Member States which share the common currency, where states still have sovereign power over their own fiscal policies. This is where the EU has run into problems due to its regional organization *and* federation/state-like characteristics: despite outlining rules related to fiscal policy to encourage better coordination among EU Member States, the Union does not have the power to implement reforms for the centralization of fiscal policy itself without the support of its members. Countries have, and generally wish to maintain, control over their ability to tax their people and raise their own revenue (i.e. a decentralized system). However, the EU needs to become more economically integrated and should pursue "fiscalization" – i.e. working towards a fiscal union and the implementation of a tax power (Wozniakowski, 2018, p. 632). Many researchers have discussed how the EU could begin the process towards creating a fiscal union and deeper economic integration, as well as the feasibility of such a process (Bargain *et al.*, 2013; Berger, Dell'Ariccia, and Obstfeld, 2018; Dolls *et al.*, 2016; Wozniakowski, 2018). There are several reforms and mechanisms for increased fiscal cooperation in the EU which have been proposed and analyzed, including tax reforms, fiscal insurance and sovereign insolvency procedures (Dolls *et al.*, 2016), and stabilization mechanisms (Bargain *et al.*, 2013), among others.

In this paper, I will analyze the feasibility of such reforms and macroeconomic mechanisms which could lead to a European fiscal union and argue that while it is economically feasible, further fiscal integration may not be able to gain enough political support to become a reality. Firstly, I will discuss taxation, as well as one of the primary proposed tax reforms, and its viability at the EU-level. I will continue by looking at other various fiscal reform propositions, including those previously mentioned. Finally, I will discuss the overall feasibility of these reforms in the context of the process towards fiscal union, from both an economic and political standpoint.

Taxation and potential reforms.

The EU has always lacked the ability to raise its own revenue through taxation and is therefore not financially independent. Its tax policy is composed of rules that Member States must follow when choosing their own system of taxation in order to ensure a certain level of fiscal coordination between countries and economic stability (Croitoru, 2015). According to Croitoru (2015), the Union's role in Member State fiscal policy is primarily to remove tax obstacles, reduce harmful tax competition, and promote broad cooperation in the tax administration (p. 115). However, Croitoru (2015) argues that there should be deeper fiscal integration, because the alternative is the disintegration of the Euro and possibly of the EU (p. 115). Due to the Euro crisis during the period of 2008 to 2012, there are concerns that the Euro does not have a stable enough framework to withstand macroeconomic shocks. In their paper on the Euro Area's need for a fiscal union, Berger, Dell'Ariccia, and Obstfeld (2018) explain that the "architecture" supporting the Economic and Monetary Union (EMU) is incomplete and that the Eurozone remains vulnerable to future economic crises while operating under a decentralized fiscal policy system. Some degree of fiscal union is needed to make dealing with these shocks more manageable, but this would be difficult to implement at the EU-level because it implies "a fundamental transfer of sovereignty" from Member States to European institutions – particularly with regard to the ability to tax one's population (Wozniakowski, 2018, p. 631).

Raising government revenue through taxation is a key principle of federations and an important function that could be introduced across the Euro Area to coordinate fiscal policy through contractionary (i.e. tax increases and/or cuts in government expenditure) and expansionary (i.e. tax cuts and spending increases) measures (Frieden and Walter, 2017, p. 375). Introducing a taxation system would transfer some fiscal responsibility over from Member States to the European institutions, thus bringing the EU closer to a full economic union with increased coordination and stability. Wozniakowski (2018) provides an explanation of the importance of fiscal reform related to taxation using the example of an asymmetric shock, explaining that when a Euro Area state is hit by a shock which affects just one country or region, it does not have the option to boost its economy through public spending and tax cuts because it must keep its national deficit low (Wozniakowski, 2018, p. 642). Not only are Member States obliged to keep their deficits low due to fiscal policy rules imposed following the European debt crisis, but Wozniakowski also (2018) points out that the EU does not have enough fiscal power itself to be able to significantly help in absorbing economic shocks, meaning the Eurozone is not sufficiently equipped to deal with economic instability and should undergo institutional reform to prevent future crises (p. 642).

Now that we have established the importance of working towards a fiscal union with the particular emphasis on a taxation system, we can look at a proposed tax and transfer mechanism as a step towards deeper fiscal integration and as an automatic stabilizer for the economy (Bargain *et al.*, 2013; Dolls *et al.*, 2016). Bargain *et al*. (2013) discuss this system extensively as a viable option for the EU, which could either partially or completely replace the current national taxation systems (p. 379). An EU-wide tax and transfer system that only partially replaces Member States' national systems would be the most efficient option, as it would involve giving up less state sovereignty to EU institutions compared to the alternative. Bargain *et al*. (2013) specifically analyze a system that replaces one third of the national taxation systems and find that it would likely increase the disposable income of a small majority of households across the EU and cause a decline in income inequality, while also increasing automatic economic stabilizers – which offset economic fluctuations without requiring the direct intervention of policy makers (Tax Policy Center, 2016) – in countries whose national tax systems have smaller stabilizers (p. 379-380). However, they also mention that there could be significant redistributive effects between Member States and a decline in the labour supply, which may make this tax and transfer system difficult to promote politically (p. 379-380). Despite these drawbacks, Bargain *et al*. (2013) demonstrate that the tax and transfer system which replaces a third of the national systems has more favourable effects than the option of keeping the current national systems in place, which perform poorly as stabilization mechanisms and even have the potential of producing destabilizing effects (p. 380).

The analysis of this particular form of tax and transfer system demonstrates that it has more beneficial effects related to disposable income and economic stability than the alternative, i.e. the decentralized and uncoordinated national taxation systems. Although, it is also suggested that EU policy makers look into new taxation methods for improving stability in the Eurozone rather than only considering those from existing federations (Bargain *et al*., 2013, p. 410). The EU is a unique body which must accommodate both the national interests of Member States and the interests of the regional organization as a whole, so while it continues to work towards a fiscal union, it may require more unique fiscal systems and mechanisms.

Fiscal mechanisms to pave the way for a fiscal union.

There are multiple proposals for macroeconomic systems and mechanisms that focus on other aspects of fiscal policy, in addition to taxation. These have largely been developed to address the issues raised surrounding the Euro crisis and thus, tend to focus on including the elements of both market discipline and stabilization (Dolls *et al.*, 2016). Researchers have also proposed banking sector reforms to help pave the way for increased fiscal integration, such as getting rid of zero-risk weights for Member State government bonds and implementing a form of debt security to support government spending (Dolls *et al.*, 2016, p. 227), although Berger *et al.* (2018) stress that a banking union and reforms are not sufficient and instead push the concept of a fiscal union through a system which allows Member States to mutually insure each other by sharing financial risk. Specific propositions include a fiscal insurance mechanism in the form of a common unemployment insurance (UI) system (Bargain *et al.*, 2013; Berger *et al.*, 2018; Dolls *et al.*, 2016, p. 211), a sovereign insolvency procedure (Dolls *et al.*, 2016, p. 211), and the general centralization of fiscal policy (Neck and Blueschke, 2016, p. 334).

The development of an economic insurance mechanism as an UI system is one of the more ‘popular’ fiscal reforms for EU institutions among researchers. This UI scheme would be focused on providing short-term income support to unemployed workers and would ideally be co-financed by national UI systems, based on Dolls *et al*.’s (2016) blueprint for fiscal union (p. 220). Dolls *et al*. (2016) explain that this system would act as an effective stabilization mechanism and strengthen the Euro Area’s general economic resilience, as the creation of minimum standards for UI at the EU-level will decrease the vulnerability of those who are unemployed in the event of macroeconomic shocks, particularly within Member States with weaker national UI systems (p. 220). Therefore, when the Eurozone is hit by asymmetric shocks, one of the most at-risk sectors of the population will not be as likely to experience severe effects and the reoccurrence of a financial crisis will be less probable. Berger *et al*. (2018) also discuss this method and suggest that this system would increase market-based fiscal discipline – another key element which can assist with absorbing shocks. Fiscal discipline will be improved through a system such as this due to the decreased risks associated with improved UI across all Member States involved in the proposed system. Overall, a fiscal insurance system resembling the one described above would have positive economic impacts on the EU, as a tool which both enforces market discipline and acts as a stabilization mechanism, while also simplifying the transition to the new regime of a European fiscal union (Dolls *et. al.*, 2016).

The proposed sovereign insolvency procedure is another key fiscal reform which would have a mutually beneficial relationship with a UI system and help the EU overcome some of the primary concerns associated with establishing a fiscal union, according to Dolls *et al*.'s (2016) analysis. The most evident concerns involve the intergovernmental aspects of the EU, referring to the Member States' desires to retain control over their own fiscal policy and the EU's inability to implement reforms without their approval. Explicitly, it is the issue of non-cooperative and insolvent countries – i.e. states who are unable to repay their debts – that complicate the process of fiscal integration. A sovereign insolvency procedure in the context of the EU could present itself as a method of debt restructuring which shifts the burden of a nation's debt from other Member State taxpayers to private creditors (Dolls *et. al.*, 2016, p. 221-222). Not only would this procedure help overcome the problem of insolvency, but it also has the potential to significantly reduce the threat of financial crises, thus further increasing the stability of the Euro and the economic markets.

Additionally, academics have analyzed the general centralization of fiscal policy and have compared the different possible structures of a fiscal union to determine what form would be most effective for the functioning of the EU. In their paper on the macroeconomics of a fiscal union, Neck and Blueschke (2016) employ a model to examine whether a monetary and fiscal union (i.e. a "grand coalition"), a fiscal union with weights corresponding to the number of Member States in the respective bloc, or a non-cooperative decentralized policy would yield the best economic results within the Euro Area. The outcomes from the model show that the fiscal union structure, with corresponding weights, would give more favourable results in terms of overall objective function compared to the non-cooperative alternative, and that the "grand coalition" proposition would produce the lowest macroeconomic costs of all three fiscal structures (Neck and Blueschke, 2016, p. 345-346). However, despite what the literature suggests about the economic benefits produced by the centralization and reformation of fiscal systems, there are complications which stem from a European fiscal union's political feasibility.

Economic and political feasibility of a fiscal union.

While the literature on the subject evidently advocates for some level of fiscal union, or increased policy coordination at the very least, there remain to be extensive limitations to bringing about fiscal integration. Concerns for the feasibility of a fiscal union in the EU are not a consequence of the economic features, as there are many proposals and blueprints for reforms which could lead to improved macroeconomic outcomes that have been outlined in the previous two sections. Nevertheless, issues related to the political feasibility are present due to Euroskeptic sentiments, a focus on domestic affairs, and the current EU voting rules (Bargain *et al.*, 2013; Frieden and Walter, 2017).

Despite the fact that numerous researchers and policy makers have pointed to the lack of coordinated fiscal policy among EU Member States as a major reason for the difficulty of fixing the Euro debt crisis, support for a fiscal union remains low. In their explanation of the political economy of the Eurozone crisis, Frieden and Walter (2017) observe that EU members tend to prefer to focus on their own domestic matters, rather than being concerned with what is in the best interest of the EU as a whole (p. 375). In this respect, most Member States are not keen on a transfer of their decision-making power over to EU institutions, even if increased fiscal coordination is necessary for financial stability in the Euro Area. Alternative attempts to increase policy coordination have been made through the Stability and Growth Pact; however, these efforts at the EU-level have largely failed and the underlying macroeconomic imbalances persist, implying the need for a common fiscal/economic purpose for the whole Eurozone (Frieden and Walter, 2017, p. 376; Neck, 2016). According to Wozniakowski (2018), the reality is that Member States have actually given up more of their fiscal power to the EU than states or provinces give up to the central government of a federation such as the USA or Canada (p. 642). This demonstrates that despite the advantages of a fiscal union in Europe, negative sentiments towards the European integration project and skepticism towards the stability of the Euro have driven Member States to be protective of their sovereign powers, such as the ability to make their own fiscal policy decisions.

The feasibility of fiscal union will also be heavily determined by voting rules within EU institutions. Bargain *et al.* (2013) discuss that economic reforms such as the ones proposed in this paper require unanimity to pass based on the current voting rules of the Council of the European Union (p. 402). This makes it unlikely that proposals for a fiscal union will be successful, given the importance of the centralization of decision-making power and the benefits and costs of fiscal systems and mechanisms. For example, reforms which have effects on disposable income will attract support from the countries whose households this will benefit, while countries who may not experience the same effects will vote in favour of keeping the current fiscal systems in place. This can be predicted based of the perceived effects of the proposed tax and transfer system, where an analysis demonstrates that a small majority of households across the EU will benefit (p. 401). Therefore, one can see how the vote would also likely produce a small majority for the reform, which is ineffective under the requirement of unanimity. Bargain *et al.* (2013) suggest that perhaps deeper fiscal integration could be possible in the framework of qualified majority voting or “enhanced cooperation”, where there is a minimum requirement of just nine EU Member States to establish advanced cooperation without the involvement of other Member States, although, implementing new voting rules would be a reform on its own and still may not make fiscal union more politically feasible (p. 401). In spite of these limitations, Wozniakowski (2018) voices some insights which have the potential to lead to increased political support of fiscal policy coordination. Most notably, he describes how “fiscalization” could trigger the democratization of central EU institutions (p. 643). Due to the universal principle of no taxation without representation, Wozniakowski (2018) argues that fiscal reforms will require the EU to introduce more representation of its citizens within its institutions, which I believe would help accumulate political support for a fiscal union because it could ease one of the EU’s persisting issues: the democratic deficit. For these reasons, the political feasibility of working towards increased fiscal integration is not necessarily as promising as its economic feasibility, but there are potential ways of improving attitudes towards fiscal union which could make a difference in the future.

Conclusion.

The EU is a complex body, given its composition of characteristics from both regional organizations and federations. This makes the process of developing a fiscal union particularly complicated, as the EU has a tripartite division of power, policy competence in most areas, and international status, while also lacking certain key features of statehood, including (1) the power to raise its own revenue through taxation and (2) the power to implement and enforce its own decisions. The EU’s reliance on its Member States for both of these things raises issues when attempting to reach a consensus on decisions such as fiscal policy coordination and general economic stability. The EU experienced the consequences of uncoordinated and insufficient policy during the debt crisis about a decade ago, but there have been minimal reforms to prevent this from happening again.

Several researchers have made propositions for fiscal systems and mechanisms which would not only improve stability and protect against financial crises, but also pave the way towards a full European fiscal union. Propositions have included a tax and transfer system (Bargain *et al.*, 2013), a fiscal insurance mechanism (Bargain *et al.*, 2013; Berger *et al.*, 2018; Dolls *et al.*, 2016), an insolvency procedure (Dolls *et al.*, 2016), and general suggestions for the potential structure of a fiscal union at the EU-level (Neck and Blueschke, 2016). These fiscal reforms have been demonstrated to have the effects of acting as automatic stabilizers in the event of asymmetric shocks, increasing disposable income, and improving market-based discipline, with the exception of some macroeconomic costs. However, political feasibility is a different story than the economic feasibility. Most EU Member States would prefer to retain control of their own fiscal policies, and due to EU voting rules, these proposed economic reforms need a unanimous vote to be implemented (Bargain *et al.*, 2013).

Although the literature demonstrates a lack of political support for a fiscal union, there are alternative voting systems (Bargain *et al.*, 2013, p. 401) and clear economic and political benefits which could be used to improve attitudes towards increased fiscal integration. Advocation for improved stability through fiscal policy coordination has the potential to not only make a European fiscal union economically viable, but politically feasible as well.

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