THE 6TH EDITION OF THE INTERNATIONAL CONFERENCE
EUROPEAN INTEGRATION
REALITIES AND PERSPECTIVES

Fiscal Federalism: a Solution for the European Union during the Crisis?

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Abstract: Addressing the cumbersome state-level fiscal crisis in the EU can be made and on the lack of a fiscal federalist its architecture. Fiscal federalism is, inter alia one of the principles of European fiscal policy, redistribution of political responsibilities between independent countries. This article survey the potential capacity of a system compared to that of the EU fiscal capacity of a system from a state with a federal organizational structure, as the U.S., addressing eight areas in crisis prevention and combating tax. This comparison helps to establish priorities for the European fiscal system, leading to the conclusion that a more federalist is not the most important measure to be adopted to combat state-level fiscal crisis in the EU.

Keywords: redistribution of political responsibility; tax policy; fiscal crisis

1. Introduction

Theory of fiscal federalism, is how best allocation of tasks at different levels of government. Exhaustively examining this issue would reach areas such as politics, sociology, national identity[1]. "The traditional theory of fiscal federalism establishes a general legal framework for the allocation of functions at different levels of government and appropriate fiscal instruments to achieve these functions" (Richard Musgrave, 1959, Oates, 1972 cited in Oates, 1999: 1121). The fiscal operations of government at federal and regional levels and through direct fiscal transfers between regions, the federal tax system provides usually redistribution (permanent transfers from richer regions to poorer ones), stabilization (anti-cyclical policies adopted federal government tax when all regions are affected by a common shock) and the risk-sharing transfers (temporary when only one region and some regions are specific to the region hit by a shock). In practice, various forms of fiscal federation (see, for example, von Hagen and Eichengreen, 1996, Ahmad and Brosio, 2006; Gichiru et al, 2009; or Bloechliger et al, 2010), even though the United States has always been primary point of reference. The euro area is facing a crisis quite pronounced, although the overall fiscal situation and prospects in this area. Focusing on eurozone crisis is a result of Greek solvency problem, the fear of contagion,

[1] These are the three models of legitimacy of the European fiscal policy presented in the literature: the EU as a problem solving entity, the model community of shared values as sources of legitimacy and the EU as an entity model based on political rights.

Greek problem is a political answer ambiguous institutional deficiencies. Finally, a higher level of fiscal federalism would strengthen the euro area, as it could help increase the responsibility of Member States in terms of fiscal policies at the state level, would allow the banking problems, and could help some more fewer conflicts of interest. Current tax reform proposals as well, strengthening the current rules, a better coordination of policies and an emergency financing mechanism, where they will be implemented should lead to some improvements. However, implementation could be deficient or lacks credibility, and could lead to disputes and a significant political risk.

However, huge differences in the centralization and redistribution, not saying much about the potential role of EU tax systems in the prevention and management of state-level fiscal crisis.

The second section of this article analyzed the potential role of the European fiscal system in the current crisis, comparing the euro area with a federal system. This section is followed by a presentation of ways in which a federalist system would help the EU in prevention and management state level fiscal crisis. The findings and results of the article should be able to respond if such a system applied in the EU fiscal policy would help in terms of current fiscal crisis.

2. The Potential Role of a EU Fiscal Federalist System in a State-Level Prevention and Management Crisis

Huge differences in the centralization and distribution did not show necessarily the potential ability of the tax system and one federalist EU, such as the U.S. fiscal management and crisis prevention. Comparing, however, these two systems can be found three areas that a federal system, can help prevent crises, three areas where there are similarities between the EU and the federal fiscal crisis resolution and two fundamentally different between the two areas systems that have an influence on fiscal sustainability.

The three areas that a federal tax system, have an active influence on the prevention of fiscal crisis refer to:

In terms of ***fiscal rules in a federal system***, they tend to be more stringent than in the EU. Thus, nationally there were more responsible behavior from this point of view. If we relate to the classic example of the federal system, as the U.S., according to a study shows that in 50 states, 36 states have set specific rules in their constitution prinvind achieve a balanced budget four requirements poor, and 10 fall between these two groups (National Conference of state legislatures, 1999 Snell, 2004). However, as shown in some studies, Defa credit swap (CDS)[1] on the bonds in some U.S. states reached much higher values during the crisis than any country in the euro area, after the collapse of Lehman Brothers in September 2008 and currently CDS state in the U.S. are similar to those in Ireland, Italy, Portugal and Spain, although none reached the levels recorded in Greece ("California is a Greater Risk Than Greece, JP Morgan chief Warns")[2].

[1] Credit default swaps (CDS) is a derivative instrument that aims to transfer the risk of exposure to fixed income financial instruments (loans, bonds) between two parties. This type of derivative has been launched by JP Morgan in 1997. A CDS buyer is protected against the risk of default of that fixed income instruments (default risk), while the CDS seller guarantees the creditworthiness of the title's subject to the swap. The risk of default is transferred from the title holder fixed income swap seller. If, for example, an investor owns a bond (assuming that it will be redeemed at nominal value) and buy a CDS, it is the buyer of the swap and receive the face value of the bond if the issuer is in the situation could not pay the related coupons and enter default. CDS is like an insurance swap because it offers buyer protection against default risk, downgrade, or any other event that adversely affects the perception of creditworthiness of the issuer (and thus the price of bonds issued by it).

[2] http://www.telegraph.co.uk/finance/financetopics/financialcrisis/7326772/California-is-a-greater-risk-than-Greece-warns-JP-Morgan-chief.html

As regards ***the scope for state or local debt in a federal system***, it is more limited because a large part of revenues and expenditures are centralized and state-level fiscal rules designed, in general, strict expenditure national, even if, in an irresponsible way, they have the potential to lead to a huge debt relative to GDP. Indeed, the combined debt of U.S. states and local governments amounted to about 22% in 2010, on average there are reasonably small differences between countries: from 9.3% in Wyoming to 33% in Rhode Island (Source: www.usgovernmentspending.com). While the euro zone and the debt-GDP ratio in 2010 ranges from 19% in Luxembourg to 124.9% in Greece (European Commission, 2010). However, even if the differences between national debt and local debt are lower in the U.S., GDP can be reached in less revenue, because a considerable part of income tax should be transferred to the center.

A federal stabilization policy can help to avoid pro-cyclical. There are good reasons to centralize a countercyclical fiscal policy (IMF, 2009, Martin, 1998): this would be better or easier coordination of policies should exploit economies of scale based on a large tax base and better loan conditions, and would also provide opportunities for sharing risk. We are again with reference to the U.S. example, indeed, during the current crisis, the federal government has allowed automatic stabilizers to operate, and adopted a major stimulus discretion including direct aid from the state budget. In the EU, such countercyclical policies were left to each Member State, with some attempt at coordination. Comparing the results of such policies in the U.S. countercyclical fiscal policy directed at the center led to fiscal consolidation at the state level. McNichol and Johnson (2010) have calculated an indicator of the state budget deficit (the difference between projected revenues for each year of reference and current services in the base year), which reflects the national tax before taking actions to eliminate the deficit. In the EU, Member States use a combination of measures to eliminate deficits, including the deployment of incentives from federal funds, budget cuts, tax and increased stocks. While the U.S. state budgets have received direct federal support through the American Rehabilitation Act and reinvested (ARRA)[1], and Member States could rely to some extent on reserves accumulated in their funds, but reductions spending and tax increases could not be avoided. In the EU, during the first phase of the crisis, in 2008/2009, almost all euro area Member States have adopted discretionary fiscal measures. Exceptions were Cyprus, Greece, Italy and Slovakia (according to European Commission, 2009). Also, in 2008-2009, primary balances have deteriorated in these countries, which means that, at least, the automatic stabilizers were allowed to proceed. In 2010, Greece adopted a series of fiscal austerity programs, and Portugal and Spain have accelerated also, fiscal consolidation, while Italy has announced plans for 2011. More recently, France and Germany have set plans for 2011 and beyond. France and Germany should not rush to fiscal consolidation measures at a time when Europe is still fragile recovery and redemption of debt in the private sector is not over yet. However, in 2010, the fiscal stance was expansionary in most euro area countries, including Germany and France. Arguably, there are countries in the euro area would have had to adopt a pro-cyclical fiscal policy during the crisis, and that there are countries that could benefit from an anti-cyclical fiscal policies. Therefore, in terms of actual results can not establish the superiority of a federal policy of stabilization, comparing the EU to a federal system like the U.S.

[1] American Recovery and Reinvestment Act of 2009, abbreviated ARRA (Published in OJ L 111-5 and commonly referred to as the Recovery Act is an economic stimulus package adopted by the U.S. Congress, 111 in February 2009. Recovery Act contains measures to create jobs and promote investment and consumer spending during the recession. In the act of state Keynesian economic tradition which holds that government budget deficits should be used to cover production shortfalls created by lower consumer spending during the recession. The measures are in nominal value of 787 billion dollars. Act includes federal tax incentives, extension of unemployment insurance and other social provisions and domestic spending on education, health, and infrastructure, including energy sector.

Proceeding with the comparison, are discussed three areas where there are similarities in the resolution. Vis-a-vis it can be said that neither the Member States of the EU nor the U.S***. there is a default mechanism ordered***, although, according to Gelinas (2010), the U.S. has a default mechanism for lower levels government, even if it is based on the rules stricter than those for private corporations.

At least before the crisis there ***was no guarantee from the central level***, short-term funding mechanisms in the euro area governments. Lately, however, Europe has implemented a formal procedure to facilitate emergency loans and the European Central Bank (ECB) began to buy government bonds of the Member States in danger due to the current crisis.

Another measure worthy of consideration in the current crisis conditions, ***refer to the currency devaluation and the real value of debt reduction***. However, euro area countries have not considered the option of devaluation, although it may stimulate economic growth as a sustainable fiscal aid, or to generate inflation, reducing the real value of public debt.

Another aspect taken into account in comparison with a federal system of the EU, something that is in favor of the latter refers to ***the power of the banking system***. According to Veron (2010), has implemented effective measures to improve its banking system, while Europe did so. In a federal fiscal system, where regulation and banking supervision are also centralized and therefore cross-border banking issues are not relevant when determining the financial system is certainly an easier process.

In terms of production and ***labor market flexibility***, the U.S. is closer to an optimum currency area than the EU in these respects. The answer to this problem is that a federal system like the U.S., the common currency can work well even when there is severe recession, as labor markets are more flexible than a system like Europe today.

3. Ways in which a federal system in the EU would help to prevent and resolve state-level fiscal crisis

The manner in which a fiscal federalist system in the EU would help to prevent and solve crises are varied and cover:

- Increased policy coherence in the euro area;
- Possibility of greater redistribution, risk sharing, and a federal anti-cyclical fiscal policy that could alleviate the effect of consolidation in those Member States which says that the policy of consolidation began in 2010;
- Reducing the possibility of a crisis at the state level by the national fiscal rules more stringent pre-crisis;
- Contributing to strengthening the banking sector in the euro area wide scheme would be introduced banking resolution.

Many solutions have been presented to the fiscal crisis in the eurozone. Governance reform in the euro area should include, in most of the following:

1. Better enforcement of fiscal discipline, which in turn will likely have two key components: strict enforcement of current rules that will suffer, in part, other amendments, greater fiscal coordination.

2. The 440 billion euros of European Financial Stability Facility (EFSF) allocated for a period of three years, can be transformed into a permanent emergency financing mechanism for the euro area member states, financed or guaranteed mechanism, primarily national contributions and the European

Stabilization Mechanism (ESM) worth 60 billion euros can also be transformed into a permanent mechanism.

3. Active involvement of the ECB at the state level to manage national crises.

4. Surveillance of private sector imbalances and a greater harmonization of economic policies.

Since the EU has a different architecture than the model policy of the U.S. federal system, and because the level of government debt in euro area Member States is very diverse, European solutions to the current crisis must not follow the American model.

At the same time as the current EU reform progress, the proposals would improve the safety policy within the euro area than that existing before the crisis. There are two main reasons to have doubts: credibility (which mainly relates to the discipline of implementing fiscal instruments) and risk policies (which mainly relates to the involvement EFSF[1] and ECB).

Introduction of Eurobonds to cover up to 60% of the GDP of Member States would lead to much higher levels of fiscal discipline than any other proposal would create an attractive market for Eurobonds, and lead to a powerful message about the irreversibility of European integration.

Taking into account all aspects of fiscal policy aimed at EU-wide tax can be said that anti-crisis measures, focused mainly in the euro area Member States to protect the European Monetary Union (EMU) and the other Member States are have left full sovereignty in this respect.

4. Results and Conclusions

In the EU, primarily from the risk of current fiscal problems and a fear that a single country to infect other countries and banking system, which is perceived as a fragile at the moment. These fears were exacerbated by the responses in the form of ambiguous policies and institutional weaknesses of governance in the euro area. But the origin of the euro area fiscal crisis is not the lack of a federal fiscal institutions with greater redistribution of risks that are typical activities of a fiscal union.

Measures of fiscal policy to be applied in all Member States not only in the euro area, especially in the countries that joined the EU, such as Bulgaria and Romania. Bulgaria stands out as a country that did not increase during 2010. In Bulgaria, was reported to the euro currency, the boom led to an overheating economy, with high salary growth and double-digit inflation and private sector external debt amounting to about 100% of GDP at the end of 2008 (IMF 2009). However, the situation was disastrous, because the Bulgarian currency reserves amounted to € 5 billion, and it was a large fiscal surplus. Also, most banks in Bulgaria are held by foreign institutions, and thus they were supported from abroad. The situation in Romania was more dramatic, however, so much so that the Romanian government had to resort to the international community for assistance. Unlike Bulgaria, Romania had a budget deficit before the crisis. The country also suffered a significant depreciation of its currency before entering in crisis exchange rate fell by more than 15% against the euro. Before the crisis, Romania currency stability a priority, and therefore had to sacrifice control over monetary policy and tolerate also higher inflation and a contraction in the domestic market. However, Romanian banking system remains well capitalized and very liquid. However, the fact that the European economy is

[1] European Financial Stability Facility (EFSF) was created by the Member States of the euro area, following decisions taken on May 9, 2010 the Ecofin Council. As part of the overall rescue package of 750 billion €, EFSF is able to issue bonds guaranteed by the Member States of the euro area up to € 440 billion for lending to euro area Member States in need, the conditions negotiated with the European Commission is be approved by the Eurogroup. EFSF is a company that was founded by 16 countries sharing the euro and was registered in Luxembourg in accordance with Luxembourg law on 07 June 2010.

recovering faster than other regions affecting Romania and in this regard a return to positive growth is delayed and somewhat weaker than was originally anticipated (IMF 2009).

Thus, incentives must satisfy three basic requirements to ensure their sustainability in terms of taxation: they must be temporary, timely and targeted.

In conclusion, fiscal federalism architecture should be the main solution to the crisis when EU states, although it would help in the prevention and control by the state debt and allow easier settlement of the problems the banking system would be also a signal of policy coherence in the euro area does not mean that the eurozone is not viable without such an architecture.

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