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A Single Fiscal Policy in the Euro Area: Vision or Utopia?

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Abstract

EMU has a unique macroeconomic framework that combines a single monetary policy with coordinated national economic and fiscal policies. Since the coordination process has some serious weaknesses despite having been modified several times in recent years, the idea of a single economic/fiscal policy is being discussed as a potential alternative solution for the euro area. On the one hand, there are reasonable economic arguments in favor of a single fiscal policy, such as the need to formulate an aggregate fiscal stance for the euro area as a whole, the need to ensure sustainable macroeconomic stabilization within EMU, and the need for a kind of insurance against asymmetric shocks. On the other hand, establishing the context for a single fiscal policy would require significant changes to the present political, institutional, and macroeconomic design of the EU. Such a context could include full political union with a federal structure, and federal institutions, including an economic government or central fiscal authority for the euro area, with a much larger and restructured general budget at the EU level, and possible abandonment of the rule that the budget must be in balance every year. Currently, neither the political will nor the social support exists in the EU for transferring further national authority to a supranational, European level. Therefore, while it may be desirable, a single fiscal policy in the euro area can only be considered for the long run; it is not an option for the short or medium term.

Key words: EMU, the euro area, economic policy coordination, fiscal policy, fiscal federalism, central/federal budget, federation, political union

JEL codes: E61, E62, E66, H77

Introduction

Economic and Monetary Union (EMU) is considered a relatively recent phenomenon, although its beginnings date to about 30 years before its formal launch in 1999 (see Box 1). Without a doubt, EMU is a very ambitious and unprecedented undertaking in world economic history because of its scale and complexity. EMU is also unique because of its macroeconomic framework. The euro area is the only region in the world that combines a centralized monetary policy with independent fiscal policies operated by individual countries. This situation is sometimes described as the coexistence of one "monetary giant" with many "fiscal dwarfs" [Tamborini 2002]. The institutional setup of the euro area, comprising a centralized monetary policy formulated in Frankfurt am Main and multiple decentralized economic and fiscal policies coordinated in Brussels is also called the "Brussels-Frankfurt consensus" [De Grauwe 2006a,b]. While most European officials regard this institutional setup as appropriate, given the current stage of European integration, some U.S. economists argue that there is an inherent conflict in the simultaneous existence of the single currency with its associated single monetary policy, and independent fiscal policies [Feldstein 2005].

The paper is organized as follows. Section I outlines the main features and weaknesses of the present European Union (EU) framework. Section II presents some proposals to improve this framework. Section III discusses economic pros and cons of establishing a single fiscal policy in the euro area, and Section IV addresses the institutional and budgetary aspects. Section V summarizes the political debate on the future of Europe, since political will on the part of the EU member states is crucial to any decisions concerning a single fiscal policy for the area. This paper is both a review of the economic literature on this topic and a contribution to the ongoing debate on the future of the EU and EMU.

1

The present EU framework for coordinating economic and fiscal policies: main features and weaknesses

In mid-December of 1997, a little more than a year before the introduction of the euro, the European Council adopted a resolution on economic policy coordination in Stage Three of EMU [European Council 1997b]. The resolution stated that, to the extent that national economic developments would influence monetary conditions in the euro area, closer Community surveillance and coordination of economic policies among the euro-area member states would be necessary. In the Council's opinion, enhanced coordination and surveillance should cover the following areas: (1) macroeconomic developments in the member states and developments concerning the exchange rate of the euro, (2) budgetary positions and policies, and (3) structural policies in labor, product, and services markets, as well as cost and price trends. Last but not least, the European Council underlined that coordination of economic policies must adhere to the principle of subsidiarity stipulated in the Maastricht Treaty.

Practical implementation of the Treaty provisions concerning economic policy has led to the definition of some specific coordination instruments, procedures, and processes that are presently being applied in the euro area, as well as in the rest of the EU. They are the following:

- the Broad Economic Policy Guidelines (BEPG), related mainly to macroeconomic and structural policies, for both the EU as a whole and for the individual member states (related mainly to macroeconomic and structural policies);
- the Stability and Growth Pact (SGP), related to coordination of fiscal policies;
- the Luxembourg process (also known as the European Employment Strategy), concerning coordination of employment policies and labor-market reforms;
- the Cardiff process, regarding structural reforms of product, services, and capital markets;
- the Cologne process, establishing the so-called "Macroeconomic Dialogue" on interactions among fiscal policy, monetary policy, and wage developments.

The adoption of the above coordination mechanisms, including the SGP, was the direct effect of EMU,[1] since previously there had been no political will to adopt a single economic and fiscal policy corresponding to the single monetary policy in the euro area. The SGP was an attempt to reconcile the conflict between the single monetary policy and independent fiscal policies in the area [Feldstein 2005]. Nevertheless, the BEPGs, and not the SGP, are regarded as the central element of the coordination process in the EU (see Figure 1), and the Council is seen as the key institution in this process (see Box 2). Almost all of these coordination mechanisms are politically, but not legally, binding; that is, compliance with their rules is voluntary and based on peer pressure; practically no sanctions for noncompliance have been stipulated. The only exception is the SGP, which is both politically and legally binding, and, consequently, stipulates various, eventually quite painful, sanctions for noncompliance. In the case of an expected or actual deficit excess over the reference value of 3 percent of GDP, the Council, acting on the Commission's recommendation, may issue an early warning to a member state and then launch the

[1] The SGP, adopted in 1997, entered into force on the day of the launch of EMU-January 1, 1999. Its principal purpose is to ensure and maintain fiscal discipline within the EU and, in particular, in the euro area. In principle, the member states shall comply with budgetary discipline by respecting two criteria: a 3-percent deficit-to-GDP ratio and a 60 percent debt-to-GDP ratio.

excessive deficit procedure (EDP) by making a recommendation to the member state and setting a deadline for corrective action. Finally, the Council may impose stronger sanctions, such as requiring the offending country to make a non-interest-bearing deposit that may be converted to a fine if, after two years, the excessive deficit has not been corrected. Although the EDP applies to all the member states, the strongest (pecuniary) sanctions may be imposed only on the euro-area countries.

In March of 2000, the European Council adopted the Lisbon Strategy, which set a new strategic goal for the EU for the present decade (2000–2010)[2] and an overall economic strategy concerning, among other matters, preparing the transition to a knowledge-based economy, stepping up the process of structural reform meant to enhance competitiveness and innovation, completing the Single Market, modernizing the European social model, and applying an appropriate macroeconomic policy mix in the EU. With reference to the coordination framework, the Lisbon European Council adopted the so-called "open method of coordination" and stated that no new coordination process was needed because the existing ones, that is, the BEPGs and the Luxembourg, Cardiff, and Cologne processes, offer the necessary instruments, provided they are simplified and better coordinated [European Council 2000]. In fact, in order to rationalize and synchronize the process of coordinating all these economic and employment policies, the Council adopted the Integrated Guidelines (2005–2008), which brought together for the first time the BEPGs and the Employment Guidelines (EGs) in a single document. And, in order to simplify and streamline extensive EU reporting, it was decided that there will be only one report at the national level (the National Reform Programme), instead of many, and also only one at the EU level (the Annual Progress Report).

As we can see, on the one hand, the EU strategic goals remain ambitious and, therefore, achieving these goals requires an overall strategy aimed at sustaining a healthy economic outlook and favorable growth prospects by applying the appropriate macroeconomic policy mix, as stated in Lisbon. On the other hand, the current EU economic coordination process and policy mix have many serious weaknesses.

In recent years, there have been reports and other papers noting many weaknesses of the EU economic coordination framework. One such report, the Sapir Report of July 2003 [Sapir et al. 2003], stated that "macroeconomic policy coordination is envisaged in the Treaty as a key feature of EMU, yet weaknesses in its current institutional setup do not favor an effective process of coordination." In particular, the report identified the following weaknesses of the European coordination process:

- An inappropriate distribution of responsibilities between the Commission and the Council in the enforcement of fiscal rules. The Council is entrusted with both policy and surveillance functions, and the Commission, which is entrusted only with the latter, lacks sufficient legal means to perform surveillance effectively, since its warnings and recommendations must be endorsed by the Council.
- Weak "political ownership" of the EU economic coordination process by the member states, undermining the effectiveness of its procedures. For example, there is no alignment between the EU coordination process and national budgetary processes.
- The coexistence within a single institutional setting of both the euro-area members and those that have not yet adopted the euro. This setup may have been reasonable when the vast majority of the EU countries were euro-area members, but that is no longer the case.

[2] The original-extremely ambitious-goal that the Lisbon Strategy set for the EU was "to become the most competitive and dynamic knowledge-based economy in the world, capable of sustainable economic growth with more and better jobs and greater social cohesion." In 2005, taking into account the global economic slowdown (2001–2003) and the rather disappointing results of the Lisbon Strategy, it was revised but remained ambitious. Its stated goals are to make Europe a more attractive place to invest and work (by, among other things, ensuring open and competitive markets), to boost knowledge and innovation (by investing more in research and development and in information and communications technology), and to create more and better jobs [European Council 2000, Commission 2005a].

Similarly, De Grauwe has argued more recently that economic governance in the euro area has deep problems and that its present institutional framework is weak. With respect to governance, De Grauwe notes the following problems [De Grauwe 2006b]:

- An imbalance between the scope of powers and responsibilities gives rise to tensions between national governments and the EU institutions. This imbalance stems from the fact that important instruments of macroeconomic policy, including management of general government deficits and debt as well as monetary policy, have been transferred to the supranational (European) level, while political accountability for decisions made in these areas (notably in the former) has remained at the national level.[3]
- Potentially conflicting unilateral decisions at the national level increase the risk of asymmetric economic shocks in the euro area. The fact that large areas of economic policy remain in the domain of national governments, allowing the governments to make independent economic decisions, for example, on taxes, social security, and wage policies, creates conditions conducive to asymmetric shocks, mainly of a political origin.
- The lack of insurance against asymmetric shocks in the euro area compounds the risk. A system of automatic fiscal transfers at the euro-area level could compensate members hit by adverse economic shocks. In turn, the euro-area members might perceive belonging to EMU as less costly in economic terms than staying outside the monetary union. Thus, the existence of such a Union-wide system of fiscal transfers could create allegiance to EMU, which is important to its sustainability.
- Incomplete economic governance of the euro area, due to the lack of a "central European government" with the power to tax and spend, which would be necessary to complement economic management of the euro area (currently entrusted almost exclusively to the ECB), and would be the only EU institution that could fully back the ECB. The absence of such a government is perceived as a serious flaw in the present euro-area governance framework

De Grauwe argues that these problems call for further steps towards a political union because without such a union the euro area and EMU are at risk of collapse [De Grauwe 2006b].

Beyond these arguments, as discussed in previous papers and the author's thesis [Szeląg 2003, 2004, 2007], there are additional weaknesses that can be added to the list of shortcomings of the EU economic-coordination framework. These weaknesses can be summarized as follows:

- The persistent risk of "free-riding" behavior by some national governments, especially in the case of conflicting national and EU interests, and the lack of fiscal discipline in the short or medium term may jeopardize the long-term sustainability of public finances, which is essential for the proper functioning of EMU.
- The fact that coordination processes are largely politically, but not legally, binding means that there is no really effective enforcement mechanism. The only exception is the SGP, but it has often been criticized because of lasting problems with its effective implementation.
- The decision-making weakness of the ECOFIN Council (the council on economic and financial issues), the key institution in the EU coordination process, undermines

[3] A relevant example is the excessive deficit procedure under the SGP. When the Commission starts this procedure in order to ensure fiscal discipline and forces national governments to make economic decisions such as limiting budgetary spending or/and increasing taxes, it bears no direct political responsibility for these decisions. In contrast, the national governments bear full political responsibility, since they will be judged (and perhaps punished) by their national voters [De Grauwe 2006b]. Another example is the EU budgetary procedure. The European Parliament is one of the key players that set the level of expenditures, but it is not associated with the related costs or revenues. Full political responsibility in this regard (for example, for increasing taxes if necessary) is left to national politicians, since the EU budget is financed primarily by national contributions. This is not the case for U.S. politicians (the President and the Congress) who set both the expenditure and revenue (tax) levels, and bear full political responsibility for their decisions [Enderlein et al. 2005].

the credibility of the entire coordination process and raises doubts about its future functioning. The Council's weakness, a result of its highly politicized nature, has been apparent in some crucial decisions that were clearly driven by obvious political motivations (see below). Such behavior may be regarded as a violation of the commonly agreed rule.

- The significant institutional imbalance in the euro area resulting from the coexistence of a single (centralized) monetary policy and numerous nationally-oriented (decentralized) economic policies which are merely coordinated. In practice, the ECB has no real counterpart responsible for the whole economic (and particularly fiscal) policy within the euro area. This constitutes a basis for potential tensions within such a partly centralized and partly decentralized macroeconomic framework and consequently may lead to macroeconomic imbalances in the future (from the perspective of the euro area as a whole).

According to some authors [Jacquet and Pisani-Ferry 2001], the undeniable efforts undertaken thus far concerning coordination of economic policy have not succeeded in creating a genuine culture of coordination in the euro area. As a result, national governments lack sufficient incentives to view national economic policies as issues of common interest, or even as a basis for the exchange of information and consultation. The commonly agreed coordination instruments (Luxembourg, Cardiff, Cologne processes) are regarded as imperfect because the procedures are too complex to be operationally transparent. The SGP does not constitute a sufficient set of principles and procedures to organize fiscal policies in a proper manner in the euro area. In particular, there is no jointly elaborated and shared economic philosophy, as should appear, for example, in the BEPG. As a result, the direction of the overall policy mix remains uncertain. Observers and markets may get the impression that the policy mix results from political and diplomatic games rather than from a consistent and active conception of the role of economic policy. Such a high degree of uncertainty is likely to influence market expectations and may involve costs that should not be underestimated [see also Gros et al. 2000].

Summing up, it seems that the statement of the European Council that there is no need to introduce more coordination processes in the EU seems accurate. The present EU framework of coordination of economic/fiscal policies is complicated enough. One might say that it is too complicated and thus not fully transparent. Therefore, the real need is to simplify the coordination framework in order to make it more understandable to the actors involved and to the public. The present EU coordination framework also has numerous, sometimes significant, weaknesses, which cause the present economic governance of the euro area to be both incomplete and inefficient. Hence, there is a need to make this framework more supportive and efficient in contributing to the overall economic performance of the EU and the euro area.

2

Proposals to improve the EU framework for coordinating economic and fiscal policies

Looking back on the EMU's experience over the more than eight years of its existence, it is evident that the EU's economic and fiscal governance has contributed to overall macroeconomic stability in the EU (and, especially, in the euro area), to non-inflationary growth, and to impressive fiscal consolidation during the run-up to EMU. But even some EU officials acknowledge that there have been failures as well as successes during that period, especially, in implementing the EU fiscal framework, and that, therefore, it is necessary to strengthen economic and fiscal coordination in order to capitalize on the advantages of EMU and the euro [Regling 2004]. Numerous proposals were made relatively soon after the launch of EMU on how to strengthen economic policy coordination within the EU. Those proposals, to be implemented in the short or medium term, were announced mainly by the European Commission, but representatives of other institutions and academia also took part in the discussion on amending the EU's economic policy coordination. This debate, which developed considerably in the early years of EMU and has continued in recent years, has been directly associated with both positive and negative significant events, as listed below:

- Introduction of the euro and implementation of the single monetary policy in the euro area (1999), developments that have already forced and will further force greater discipline and cohesion of national economic and fiscal policies of the euro-area member states;
- Global economic slowdown (2001–2003) and much slower recovery in the euro area than in other developed regions of the world, particularly the United States;
- Problems with effective implementation of the EU fiscal framework (SGP), resulting in serious tension between the EU institutions: the Council and the Commission (2003–2004);
- EU enlargement to include many more member states (from 15 to 25 in 2004, and then to 27 in 2007). The fact that the economies of the new members are much less developed than the old ones has further complicated the coordination process, notably, after the euro-area enlargement that started in 2007 with Slovenia, and adds Cyprus and Malta in 2008.

In the early years of EMU, it was proposed that the euro-area countries ensure more efficient functioning of the Eurogroup by increasing its powers and formalizing its operational framework. There were even suggestions to set up an ECOFIN Council for the euro area by establishing a "euro-area Council" or a "Eurozone Economic Policy Council." There was also a proposal to extend the use of qualified majority voting in the decision-making process related to economic policy, based on the argument that, with a single currency, it no longer makes sense to apply unanimity to fiscal and social affairs within the Single Market. Other proposals indicated the need to institutionalize the dialogue between the various actors involved in the creation of the policy mix within the euro area (These actors include the president of the ECB, the president of the Eurogroup, and the Commission's representative in the ECB Governing Council), and to ensure a single voice of the euro area in international forums by having a single body represent the euro area on all relevant international issues: economic, monetary, and financial. [Commission 2001a, Commission 2002a,d, Jacquet and Pisani-Ferry 2001, Sapir et al. 2003]. The Commission also proposed streamlining the annual economic and employment policy cycles by presenting and adopting both the BEPG and the EG at the same time as a single package, and by putting more emphasis on the medium-term orientation of economic and employment policy strategy [Commission 2002c].

Given that sound public finances are essential for the proper functioning of EMU, the process of coordinating fiscal policies (SGP) was always regarded as the issue of utmost importance in the euro area, and was therefore monitored very carefully. Practical experience with the SGP showed that there were some significant achievements but also important shortcomings. According to critics, the original SGP reduced fiscal flexibility and hampered automatic stabilizers, worked asymmetrically and focused mechanistically on an arbitrary level of nominal deficits, disregarded the aggregate fiscal stance of the euro area, focused on short-term commitments, hence disregarding long-term sustainability, discouraged structural reforms and public investments, failed to sanction politically motivated fiscal policies, and created tensions and conflicts between the member states and the EU institutions [see, for example, Eichengreen and Wyplosz 1998, Hughes Hallett et al. 1999, Balassone and Franco 2001, Ballabriga and Martinez-Mongay 2002, von Hagen 2002, Buti, Eijffinger, and Franco 2003, De Grauwe 2006b]. Meanwhile, it was argued that much of the academic criticism related to the SGP was exaggerated and that therefore the SGP should be regarded as "not the best, but better than nothing" [Heipertz 2003]. Nevertheless, in view of the criticism, numerous proposals for changes in the SGP were raised and considered in the early years of EMU.

A turning point in the status of the SGP was the Council's infamous decision on November 25, 2003, concerning the excessive deficits at that time in Germany and France [Council 2003]. Despite the fact that both countries had clearly breached the reference value of 3 percent of GDP,[4] the ECOFIN Council, contrary to the Commission's recommendations, decided to hold in abeyance implementation of the provisions of the EDP and to refrain from imposing sanctions on France and Germany.[5] The Commission and the ECB deeply regretted the Council's decision. The ECB stated that the Council's decision undermined the credibility of the institutional framework and confidence in sound public finances in the euro area [ECB 2003], and the Commission, acting as the "guardian of the Treaty," decided to challenge the matter before the Court of Justice in January 2004. In its judgment on July 13, 2004, the Court stated that the Council could not depart from the rules laid down by the Treaty and the SGP, and accordingly annulled the Council's conclusions of November 25, 2003 [Court of Justice 2004].

These events eventually led to reform of the SGP in 2005. At the end of June 2004, just before the judgment of the Court of Justice, the European Council adopted the *Declaration on the Stability and Growth Pact* [European Council 2004]. In June and September 2004, the European Commission presented two communications on strengthening economic governance and clarifying the implementation of the SGP [Commission 2004a,e], in which it considered several elements aimed at strengthening the SGP, including the following:

- Placing more focus on public debt and the sustainability of public finances in the surveillance of budgetary positions and clarifying the Treaty term "satisfactory pace of debt reduction";

[4] To some extent, the situation was similar to that of the early 1970s when the Werner Plan was adopted. Although the implementation of that commonly agreed plan was underway, the member states-in the event of the first oil shock-decided to abandon it, caring primarily about their national economies. Alike, Germany and France-in the event of the recent global economic slowdown-decided to disregard the commonly agreed rules of the SGP, which proved to be too rigid at that time for their economies.

[5] It seems that Germany and France, regarded as the core of EMU, did not fully believe that the Council (composed of them and other fellow countries) could easily impose sanctions on them. If the Council decided to use even some "lighter sanctions" (such as notices) at that time, it could have been forced to use "harder sanctions" (eventually pecuniary ones) at a later stage. But, as Buti argues, "the experience of the early years of EMU showed that the Council was not prepared to use the 'nuclear option' of pecuniary sanctions, especially vis-à-vis large countries" [Buti 2006].

- Looking at more country-specific circumstances in defining the medium-term budgetary objectives (MTO), and abandoning the uniform "one-size-fits-all" approach to all countries;
- Considering general economic circumstances and developments, for example, periods of sluggish-that is, slow but still positive-growth, in the implementation of the EDP;
- Ensuring early action to correct inadequate budgetary developments-not only in "bad times," when deficits approach the 3-percent reference value, but also in "good times."

Finally, following the Commission's communications, the ECOFIN Council prepared and submitted its report on "Improving the Implementation of the Stability and Growth Pact" to the Spring European Council in Brussels, in March 2005 [Council 2005]. That report, endorsed by the European Council [European Council 2005], included proposals to strengthen the effectiveness of the Pact in its ability to both prevent and correct problems, summarized briefly as follows:

- Reform of the preventive arm of the Pact, focused mainly on redefining the medium-term "close-to-balance or surplus objectives" (MTO) and the adjustment path to the MTO, and on incorporating major structural reforms in defining the adjustment path.
- Reform of the corrective arm of the Pact, focused on reaffirming the reference values, redefining some issues concerning excessive deficits, including redefining a "severe economic downturn" and "other relevant factors" that might cause the excess over the reference value, taking into account systemic pension reforms, and extending the EDP deadlines.

Reforming the SGP required introducing legal amendments to relevant regulations that would be binding on the member states. But in line with the Council's preference for keeping changes to those regulations to a minimum, only some technical amendments were included, and agreements on structural/pension reforms were left to be addressed in the code of conduct [for more details on the SGP reform, see Commission 2005c, 2006c, 2007d].

The overall assessment of the 2005 SGP reform was mixed. On the one hand, there were some positive reactions. For example, the Commission stressed that the SGP reform had reached the appropriate balance between economic rationale and simplicity, as well as the balance between maintaining rigorous application of the rules-based system and allowing more room for assessment and judgment [Almunia 2006]. And the OECD praised the amended EU fiscal rules for, among other things, their increased flexibility in implementation and their medium-term (or even long-term) orientation, achieved by giving greater weight to public debt, long-term sustainability, and structural reforms [OECD 2005]. On the other hand, the reform also received critical reviews. Some authors noted that the reformed Pact was excessively vulnerable and prone to various opportunistic interpretations and that it failed to tackle the root causes of fiscal imbalances within the euro area [Coeuré and Pisani-Ferry 2005]. The SGP fiscal rules also continued to receive criticism for their biased incentives, since there is a "hard" 3-percent ceiling for deficits, and there are no legal instruments to enforce the "close to balance or in surplus" rule, which are essential to providing the necessary room for maneuver during downturns [OECD 2005]. Some observers criticized the revised SGP as a "watering down" of the rules [González-Páramo 2006], while others argued that the reform had effectively abandoned the SGP rules and left the way open to much larger sustained deficits in the euro area [Feldstein 2005]. Some authors even stated that, given the numerous exceptions concerning the application of the 3-percent budgetary ceiling, as well as the greater discretion left to the Council within the EDP, the Pact had become, de facto, dead [Buiter 2005, Calmfors 2005]. In general, evaluating the reformed SGP on the basis of specific criteria, the overall assessment has been neither fully negative nor fully positive [Buti, Eijffinger, and Franco 2005, Buti 2006], since the new Pact improved over the old in some areas, but deteriorated in others (see Tables 2 and 3).

In sum, the introduction of the euro has influenced the EU's economic policy from the very beginning of the launch of EMU. And it seems that over time the impact of the single currency will be even stronger. The reform of the SGP in 2005, similar to its adoption in 1997, was a direct effect of EMU. The fact that these reforms were implemented confirms that EMU and the single monetary policy need a reliable, solid fiscal framework in the euro area. The proposals thus far and the results of improving and strengthening coordination of economic/fiscal policies in the euro area seem to have been sufficient to have resolved some current problems in the short/medium term. However, they do not seem to be sufficient to provide the complex economic policy framework that will be needed within EMU in the long run, and it is likely that EMU will require further amendments of the euro-area economic/fiscal framework in the future. Therefore, the debate on the future of European economic policy, which developed before the introduction of the euro and has continued in recent years, is still alive in the economic literature. In particular, academic discussion has focused on whether economic and fiscal policy in the euro area should still be a matter of coordination or whether it should evolve over time into a single economic/fiscal policy, formulated at the supranational level.

3

3

A single fiscal policy in the euro area: economic pros and cons

Should economic/fiscal policy in the EU (and particularly in the euro area) be coordinated or should it evolve into a single policy formulated at the supranational level? It is argued that it is worth considering whether this idea is feasible and desirable in the long run, given the fact that coordination of economic/fiscal policies has some serious limitations. Although many papers in the economic literature confirm the advantages of policy coordination, many other analyses conclude that economic coordination is relatively costly (because of substantial monitoring costs), time consuming, and, at times, insufficiently transparent. There are also practical problems associated with policy coordination, such as decision-making delays due to difficulties with gathering and analyzing all necessary information in a timely and effective manner, confusing responsibilities, distorting incentives, and reduced accountability of individual policymakers [Issing 2000]. In general, benefits from international policy coordination are usually rather limited [Ghosh and Masson 1994]; moreover, the gains from coordination become smaller rather than larger as countries become more integrated [Obstfeld and Rogoff 2002]. It is also argued that the larger the economic externalities and cross-border spillovers associated with decentralized policy actions, the stronger the case for shifting decision-making powers to a higher level of government, possibly even to a supranational institution that can internalize all externalities and spillovers and deliver more efficient policies [Masson 2000, Beetsma, Debrun, and Klaassen 2001, Weyerstrass et al. 2006]. For all these reasons the idea of a single economic/fiscal policy is worth considering as an alternative solution to policy coordination in the euro area.

As it is known, EMU-and in particular the proper functioning of the single currency-requires the appropriate policy mix.[6] Therefore, one can ask whether the present combination of the single monetary policy and decentralized economic/fiscal policies is able to ensure such an appropriate policy mix within the euro area, or not. On the one hand, prior to the introduction of the euro, decentralization of economic/fiscal policies was regarded as an advantage, and it was argued that individual countries would be able to adapt fiscal and structural policies to their own specific situations and problems. On the other hand, it was noted that such decentralization would complicate the task of achieving the appropriate policy mix at the euro-area level, because inadequate national policies would inevitably have spillover effects on other countries through their implications for the single monetary policy and the exchange rate for the euro [McDonald, Świderski, Knot 1998]. The large economic externalities and cross-border spillovers caused by decentralized economic/fiscal policies argue in favor of shifting decision-making powers from the national to the supranational level.

There was also debate on the conduct of fiscal policy in EMU. On the one hand, some economists, noting the loss of independence in the conduct of monetary and exchange rate policies, called for a more active use of fiscal policy in the euro area in order to correct country-specific macroeconomic imbalances or shocks. According to the European Commission, better stabilization at the national level could have positive spillover effects at the euro-area level by facilitating price stability, the primary objective of the ECB, since it was argued that inflation in the euro area would be less volatile with more active stabilization at the national level [Commission 2004d]. On the other hand, some

6 According to the European Commission, an appropriate policy mix can be defined as "*a combination of monetary and fiscal policies that ensures price stability and keeps economic activity close to its potential level*" [Commission 2006c].

authors argued that the active use of fiscal policy should be avoided in EMU [Auerbach 2002]. In particular, some pointed to the risk of "free riding" at the national level and noted that inappropriate fiscal policies, especially if carried out simultaneously by many countries, could increase uncertainty about the overall effect on the policy mix, and, in turn, prompt countervailing action by the ECB. It is argued that this "free riding" problem becomes more and more important in the euro area as the number of members gradually increases [Feldstein 2005]. Moreover, taking into account that trade in EMU was likely to increase, it was expected that free riding might reduce the effectiveness of discretionary domestic fiscal policy. For these reasons, in opinion of many economists, national fiscal policies should be limited to enabling the full operation of automatic stabilizers. But there were some doubts concerning the effectiveness of automatic stabilizers, for example, whether they would always be helpful in stabilizing the economy and whether they would be sufficient in the case of strong asymmetric shocks [Commission 2004d].[7]

Some European officials, including the President of the ECB, believe that the present framework for fiscal policy in the euro area is sufficient and that there is no need to change it radically. In Trichet's opinion, the SGP is an important element in the structure of EMU, satisfying the two questions that were most frequently asked at the start of EMU, and still remain entirely relevant:

- How can there be a balanced euro-area-wide policy mix without a single fiscal policy?
- In the event of an asymmetric shock affecting one particular economy in the euro area, what would be the contribution of the fiscal channel without a federal budget?

As far as the former is concerned, in Trichet's opinion the SGP makes it possible to keep national fiscal policies balanced within adequate bounds of flexibility in order to rule out any dysfunction of EMU. And with reference to the latter, the SGP stipulates that national budgets must be balanced or in surplus in normal times, in order to maintain necessary reserves for worse economic periods. Stabilizing reserves from surpluses may be used either when an adverse shock affects the euro-area economy as a whole, or for national budgets if an asymmetric shock impacts a particular economy. Thus, as long as the SGP criteria are met, there is no need for a single fiscal policy or a federal budget in order to have a consistent EMU [Trichet 2003]. Ironically, this opinion was declared just a month before the infamous decision of the Council of November 2003 (see Section 2), which undermined the credibility of the SGP and confirmed some weaknesses of the EU economic coordination process.

In contrast to the above opinion of the President of the ECB, some U.S. economists, who stated that the Council's decision of November 2003 and the reform of the SGP of March 2005 undermined the fiscal rules in the euro area, are not convinced that the present euro-area fiscal framework is appropriate to ensure the long-term sustainability of EMU. For example, Feldstein argues that the current European institutional structure with a centralized monetary policy and decentralized fiscal policies creates a very strong bias towards large and chronic fiscal deficits and rising debt-to-GDP ratios in the euro area. In his opinion, the reason for this bias is that there is no market feedback to discipline large budget deficits run by the euro-area member states. This is because the existence of the single currency and the single monetary policy means that excessive fiscal deficits in the euro-area countries do not cause increases in their national interest rates[8] or changes

[7] According to the European Commission, the effect of automatic stabilizers depends largely on the type of shock hitting the economy. For example, empirical evidence shows that automatic stabilizers are quite effective in the case of shocks to private consumption, while they are less effective in the case of shocks to investment or external demand [van den Noord 2000; Commission 2001b; Commission 2004d].

[8] Long-term interest rates in the euro area are very similar (basically the same) in the euro-area member states regardless of whether they run large fiscal deficits or surpluses. For example, as of the end of 2006, in the "deficit" countries, Germany, France, Greece, Portugal, and Italy, long-term interest rates were 3.8%, 3.8%, 4.1%, 3.9%, and 4.0%, respectively-very close to the rates of the "surplus" countries, Spain, Ireland, and Finland: 3.8%, 3.7%, and 3.9%, respectively (see Figure 3).

their exchange rates, as would be the case in countries with their own currencies. And lacking discretionary monetary policy or automatic and cyclical interest-rate or exchange-rate adjustments, a country can stimulate aggregate demand in response to an economic downturn only through fiscal policy. Thus, there would be pressure on national governments in the euro area to use fiscal policy to counter cyclical downturns. But Feldstein argues that while, in principle, fiscal policy could be a revenue neutral change in fiscal incentives, for example, an investment tax credit offset by a temporary rise in the corporate income tax rate, the usual fiscal responses of governments to economic downturns are tax cuts that increase their budget deficits. In Feldstein's opinion, such a situation, usually starting as a temporary deficit in response to a cyclical downturn, might, if continued and never properly corrected, eventually lead to cumulative budget deficits that are harmful not only to those countries that incur them but also to the other euro-area members, because the value of the euro and long-term real interest rates, reflecting the value of government obligations in these countries, will eventually respond to the size of total fiscal deficit and public debt in the euro area as a whole. And, as Feldstein notes, "large cumulative deficits may also lead to increased pressure on the ECB to permit higher inflation as a way of eroding the real value of those obligations." Therefore, he concludes that the current combination of a centralized monetary policy and a decentralized fiscal structure in the euro area increases the need for effective countercyclical fiscal policy, and thus an effective political agreement among the euro-area members is needed to prevent large, chronic, and cumulative fiscal deficits within EMU [Feldstein 2005].

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The key economic argument in favor of a single fiscal policy is related to potential asymmetric economic shocks in the euro area, and it is based on the theories on optimum currency areas (OCA) developed in the 1960s by Mundell, McKinnon, and Kenen and later complemented by other authors. One of the key aspects of the OCA theories is potential economic shocks that could negatively impact part of a currency area or a monetary union. Such shocks may be symmetric or asymmetric. The OCA theories focus mainly on asymmetric shocks, for example, country-specific/regional/sectoral shocks. They emphasize that it is necessary for the members of a monetary union to have at their disposal relevant adjustment instruments to cushion adverse shocks. But in a monetary union, such tools as monetary and exchange rate policies are no longer available for individual countries. Therefore, the OCA theories stipulate some adjustment mechanisms that can be used in the case of asymmetric shocks: (1) labor mobility, (2) price and wage flexibility, and (3) fiscal policy (interregional budgetary transfers). Although the euro area is a monetary union, it is not an optimum currency area, since it does not fulfill some important OCA criteria. Important among these criteria are considerations of labor mobility and price/wage flexibility. Mobility and flexibility are much lower in Europe than in the United States, and this rigidity may cause prolonged periods of economic slowdown and high unemployment in some euro-area countries/regions-mainly those with lower productivity.[9] As a monetary union, the euro area is potentially exposed to adverse shocks that could negatively impact only some regions or countries while not affecting others.

It is worth considering whether asymmetric shocks are frequent or rare in the euro area, and therefore whether they are a real problem or a merely a speculative danger for EMU. The economic literature contains some theoretical expectations in this regard. Prior to the launch of EMU, there were contradictory opinions on the probability of asymmetric

[9] For example, in the United States, a serious decline in demand for products in a given state usually leads usually to a relative decline in its labor force via increased out-migration and increased in-migration, as well as to a decline in relative wages of workers in the state (such was the case in Massachusetts some years ago) [Feldstein 2005]. In contrast, in Europe, taking into account language and cultural differences, economic and socio-psychological factors (such as wage equalization across regions, benefit systems, housing market rigidities, and the role of local families in providing social security), geographical labor mobility is low-not only among the EU or euro-area countries but also among various regions within the same country, for example, southern and northern Italy. Some EU regions exhibit stubbornly high unemployment rates (see Figure 7), that can be explained-at least to some extent-by the fact that wage developments are often misaligned with local labor market conditions [Commission 2004d, OECD 2000, 2004].

shocks and, consequently, on the necessity of having relevant adjustment capacity. On the one hand, some economists argued that the likelihood of asymmetric shocks would diminish in EMU because stronger economic integration among the euro-area countries would result in more highly inter-correlated business cycles in the region. They indicated that there was empirical evidence (30 years of data from 20 industrialized countries) on the existence of a strong positive link between the degree of bilateral trade intensity and the cross-country bilateral correlation of business cycle activities [Frankel and Rose 1998]. Furthermore, some years after the launch of EMU, the main EU institutions argued that the strong synchronization of the business cycles among the euro-area members, and their high real convergence, should contribute to reducing the likelihood of asymmetric shocks in the area [Commission 2004d, Issing 2005]. On the other hand, some economists, notably Krugman, in his famous *Lessons of Massachusetts for EMU*, argued that the process of economic integration (mainly, the expansion of interregional trade as a result of EMU) would lead to greater local/regional specialization and concentration of production, which might cause some euro-area regions to become more vulnerable to idiosyncratic (sectoral/industry-specific) shocks and, in turn, lead to an increased likelihood of various region-specific crises and recessions within the euro area [Krugman 1991, 1993]. Such a phenomenon could potentially result from lower trading costs under EMU leading to greater industrial specialization and concentration along geographical borders. In practice, however, there is little evidence for increased specialization so far [OECD 2004] and, as some authors argue, trade integration effects may dominate, resulting in greater dispersion rather than increased concentration of economic shocks in the euro area [Duval and Elmeskov 2005, 2006].

Turning to actual economic developments both before and after the launch of EMU, the findings in the literature concerning asymmetric shocks in the euro area are also somewhat contradictory. Some authors and institutions argue that although the euro area has already experienced some economic shocks in its relatively short history (for example, the Asian financial crisis (1997–1998), the global economic slowdown (2001–2003), and the oil price hikes (1999–2000, and then 2004–2007), it has not yet experienced truly asymmetric shocks. The oil price hikes were supply shocks, while the other two were demand shocks [see, for example, Buti and Sapir 2002, Commission 2004d]. However, other authors note that, surprisingly, asymmetric shocks have remained relatively large within the euro area and suggest that this is related to the fact that unilateral decisions made by national governments on taxes, social security, and wage policies create the scope for such shocks. An often-cited example of such a shock was the unilateral decision by the French government, taken in February 1998, and effective in January 2000, to shorten the length of a work week in France from 39 to 35 hours in order to cope with high unemployment by forcing employers to hire additional workers. It is argued that the effect of this decision in France was equivalent to a negative supply shock that affected aggregate output in the euro area and the conduct of monetary policy of the ECB. Another example cited was the unilateral decision of the German government to apply a policy of tough wage moderation (a strong decline in nominal wage increases) since 2000, while most of the other euro-area members maintained more or less constant wage increases (see Figure 5). This action spectacularly improved Germany's competitiveness within the euro area at the expense of other countries, for example, Italy, France, the Netherlands, and was regarded as a so-called "beggar-thy-neighbor" policy. It had a serious impact on the other EMU members, since it forced them to apply radical policies of wage moderation to regain their competitiveness within the euro area [De Grauwe 2006b].

Thus, according to this line of argument, asymmetric shocks do not seem to be a rare occurrence in the euro area, and they should be regarded as a real, and not just a speculative, problem for EMU. An implication is that the euro area as a whole would benefit from effective adjustment mechanisms to neutralize the negative effects of asymmetric shocks. Empirical evidence confirms that the euro area would not be able to

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use either labor mobility or price and wage flexibility effectively to absorb the adverse effects of asymmetric shocks [Decressin and Fatás 1995, Obstfeld and Peri 1998, OECD 1999, HM Treasury 2003]. There are many papers in the economic literature confirming weak responses of national/regional labor mobility and wage differentials to idiosyncratic (country-specific or region-specific) shocks in the euro-area member states; this is usually regarded as evidence of the rigidity of the area's labor markets, in contrast to the market flexibility of the United States.[10] As a result, changes in employment and unemployment in the euro area are relatively sluggish and do not fully reflect the actual phases of the business cycle (see Table 6).[11] And this rigidity obstructs the smooth functioning of the euro-area economy and keeps it from maximizing its potential growth over the business cycle. The solution proposed by these authors is to implement an area-wide fiscal policy formulated for the entire monetary union. Under a single fiscal policy characterized by the existence of a relatively large supranational budget, the argument goes, it would be possible to direct some budgetary transfers to regions/countries affected by an asymmetric/idiosyncratic shock. At the time of such a shock, the central euro-area budget would be able to transfer sufficient funds to the affected regions/countries from funds from regions/countries not affected by the shock, as is the case in the United States.[12] Such budgetary transfers could be released automatically at the time of an asymmetric shock, and therefore, serve as insurance against such shocks.

The system of interregional fiscal transfers outlined above, known as "fiscal federalism," is typical of federal countries that are also monetary unions, such as the United States, Canada, and Germany [see, for example, Oates 1972, 1991, 1999]. One of the key functions of the federal budgets of these countries is to ensure overall macroeconomic stabilization. There are various findings in the economic literature concerning the efficiency of budgetary transfers in providing macroeconomic stability. Most studies on the effectiveness of federal budgets in absorbing the negative effects of asymmetric shocks (measured as a percentage of those effects that could be absorbed by transfers from the central/federal budget) were published in the 1990s (see Table 1). Initially, some authors estimated the stabilizing (and sometimes also the redistributive) effects of the U.S. and Canadian budgets to be as much as 30–40 percent [Sala-i-Martin and Sachs 1991, Bayoumi and Masson 1995]. But most authors indicated at the time that the stabilization effect is, on average, around 10–20 percent in the United States, and more or less the same in Canada [Goodhart and Smith 1993, Obstfeld and Peri 1998, Mélitz and Zumer 1998, 2002]. In any case, the degree of stabilization that could be provided by the federal budget seems to be considerable-especially in comparison with the stabilization and redistributive effects of the EU budget, estimated in the 1990s at between 0.5 and 3 percent [Sala-i-Martin and Sachs 1991, Costello 1993a, Bayoumi and Masson 1995].

[10] However, some authors argue that such idiosyncratic shocks average, by definition, to zero (since following such shocks unemployment increases in the regions affected by negative shocks as much as it decreases in the regions hit by positive shocks), and thus, one cannot make an explicit link between the (lack of) adjustment at the national/regional level and the aggregate unemployment rate of the EU or the euro area. Moreover, in their opinion, the emphasis on the reaction to short-run idiosyncratic shocks is unlikely to explain the permanent unemployment differentials across regions in many European countries [Pench, Sestito, and Frontini 1999].

[11] It was confirmed in practice during the recent global economic slowdown. Analyzing data for 2000–2002, it is apparent that the U.S. unemployment rate grew significantly at the beginning of the downturn (by almost 2 percentage points), while the euro-area rate was more or less the same at that time. Also, after the slowdown, when the U.S. unemployment rate declined quite a lot (by almost 1 percentage point between 2003 and 2005), the euro-area rate was practically constant. In general, the euro-area economy's reactions to the downturn were not only much weaker but also later than the reactions of the U.S. economy (see Table 6).

[12] As explained by Feldstein, a decline of economic activity in a given U.S. state automatically causes a substantial decline in the flow of taxes to the federal budget in Washington D.C. from residents and businesses in that state, and, at the same time, an increase in transfer payments from the federal budget to that state. The scale of this mechanism is considerable-roughly about 40 percent of the local decline in GDP. In his opinion, "this net fiscal swing constitutes a significant external fiscal stimulus to the local economy; in contrast, with the decentralized European fiscal system, a fall of GDP in any country causes a contraction in tax revenue in that country but very little net transfer from outside" [Feldstein 2005].

Given the relatively high effectiveness of federal budgets and interregional fiscal transfers in cushioning the potential effects of asymmetric shocks, some scholars proposed, in the 1990s, establishing "European fiscal transfer schemes" [for an overview, see Pacheco 2000]. One of the first and most famous of these proposals recommended the creation of a "European stabilization mechanism,"possibly in two variants: a "full stabilization mechanism" to deal with all asymmetric shocks and a "limited stabilization mechanism" that would be activated only in the event of large shocks exceeding an agreed-upon level [Italianer and Vanheukelen 1993]. In the subsequent years, between 1993, when the Maastricht Treaty stipulating EMU took effect, and 1999, when the euro was introduced, there were further proposals to establish similar federal fiscal schemes in the EU, including a "Community financial mechanism for regional stabilization" [Goodhart and Smith 1993], a "shock absorption mechanism" [Mélitz and Vori 1993], a "temporary and asymmetric shock absorption mechanism" [Hammond and von Hagen 1995], and an "EU stabilization instrument" [European Parliament 1998].

There are also counterarguments in the literature concerning the idea of establishing a European system of interregional fiscal transfers. Some authors argued that interregional transfers and taxes could stabilize either regional employment or consumption, but not both [Kletzer and von Hagen 2000]. Other authors, like Fatás, who, having stated his opinion that some previous studies had overestimated the interstate insurance benefits of the U.S. federal budget, argued that the EU already has national tax systems that could insure more than 50 percent of a hypothetical European fiscal federation; that, even if such a federal transfer system were implemented in the euro area, there would be large cross-country differences regarding the potential insurance benefits of such a federation; and that those benefits would decrease over time. Thus, in his opinion, "the potential to provide interregional insurance by creating a European fiscal federation is too small to compensate for the many problems associated with its design and implementation" [Fatás 1998]. With reference to the above arguments, it seems that even if a European fiscal federation were able to ensure only about twice as much insurance as the present national tax systems, this would still provide considerable relief to affected regions/countries.

Thus, there are economic pros and cons related to the idea of a system of interregional budgetary transfers as insurance against asymmetric shocks in the euro area. And although the idea was quite popular in the 1990s in the economic literature, there was no political will to put it into practice, and it seemed to be abandoned. But, surprisingly, some top European politicians, among them, some regarded as federalists, and some as anti-federalists, proposed it again relatively soon after the launch of EMU. In 2000, Fischer, then German Vice Chancellor and Foreign Minister, suggested transforming the EU into a federation, a precondition for fiscal federalism). And in 2001, during the debate on the future of Europe, Jospin, French Prime Minister at the time, proposed setting up a short-term economic action fund to support any member state suffering from the effects of world economic turbulence [Fischer 2000, Jospin 2001] (see Section 5). Even relatively recently, the idea seems to have been kept alive. In 2005 and 2006, some authors who were in favor of a European transfer mechanism to stabilize economic regional cycles proposed establishing a European corporate tax scheme and a European unemployment insurance system [Dullien and Schwarzer 2005], as well as a European system of budgetary transfers that could serve as insurance against asymmetric shocks [De Grauwe 2006a,b].[13] Those proposals-mutually complementing-seem to be interesting and well argued (including especially economic and financial arguments), and thereby they will be described in greater detail in this section.

[13] The European proposals discussed above seem to be a response to U.S. publications that described fiscal policy in the EU (or in the euro area) as follows: "the small size of the EU budget implies there can be no EU-wide tax-transfer system for risk-sharing. There is no automatic response to shocks that hit some parts of the EU more than others, and no centralized income tax that will automatically absorb less from countries that are in recession and more from countries that are booming. Nor is there a centralized unemployment insurance scheme that could provide differential help to those countries with relatively high unemployment" [Gramlich and Wood 2000].

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The authors who proposed establishing a European corporate tax scheme and a European unemployment insurance system noted that diverging regional economic cycles are a source of serious pressure on the euro area. In their opinion, the euro area is not a truly single economic entity, since it is split up into regional blocks, like Spain and France, which are characterized by relatively high growth with high inflation, and Germany and the Netherlands, which have relatively low growth and low inflation.[14] In such circumstances, the single monetary policy (and the ECB's interest rate) is no longer suitable for all members of the euro area. For example, the ECB's interest rate is regarded by Germany as too high and as constituting an additional obstacle to growth. This is because the ECB's interest rate makes financing costs in Germany relatively high, a situation that is problematic for German companies operating mainly in the domestic market (most German SMEs produce goods and services exclusively for the German market). And what is problematic for German companies may, in turn, become problematic for German banks.[15] Finally, an inappropriately high ECB interest rate can lead to a regional economic downturn of considerable duration, since economic cycles are longer in the euro area than in the United States. The differential recovery time results from the fact that European product and capital markets are not fully integrated but remain segmented to some extent, causing reversal of competitive imbalances between European regions to take longer [Dullien and Schwarzer 2005].

In view of the above arguments, Dullien and Schwarzer stated that regional economic cycles put serious pressure on the euro area, and might even generate the potential for political conflicts, and that therefore a transfer mechanism is needed to stabilize regional economic cycles at the European level. They indicated that the United States had proved successful in stabilizing its regional economic cycles via: (1) national income tax revenues and public sector spending, and (2) unemployment insurance contributions and payouts. The idea behind such mechanisms is simple: during an economic upturn, a given state contributes more tax revenue to the federal budget, and during an economic downturn, it receives unemployment benefits from that budget. According to the authors, empirical research suggests that these mechanisms can offset about 15–20 percent of regional economic downturns. Therefore, they believe that a similar stabilization mechanism could make sense for the euro area, too, and they proposed establishing a stabilizing mechanism consisting of two pillars:

(1) a European corporate tax scheme. Through this mechanism, the EU budget could collect taxes equal to about 10 percent of corporate profits. Hence, the member states would no longer have to pay their national contributions to the EU budget. The member states, like states in the United States, could levy additional corporate taxes, but, since national budgets would no longer need to collect money to pay national contributions to the EU budget, those taxes could be lower, and the overall levels of corporate taxation and national budget deficits would remain unchanged;

[14] In general, one can agree that the euro area is divided into "regional blocks" in terms of growth and inflation rates, but, analyzing data for 1997–2006, it seems that the composition of the blocks is somewhat different. While Germany is, in fact, characterized by low growth and low inflation, and Spain by high growth and high inflation compared with the euro-area average over the period, the Netherlands and France, both seem to be characterized by rather medium growth and medium/low inflation. The other member states with both high growth and high inflation (like Spain) are Greece and Ireland (see Figure 2, Table 4).

[15] As argued by the authors, the mechanism is the following: economic problems of enterprises caused by high financing costs may lead to their bankruptcies. These bankruptcies, if associated with loan defaults, may undermine the liquidity of banks. As a result, banks may restrict their lending policies in order to avoid further defaults, and this in turn may exacerbate the situation of enterprises by limiting their financing sources. Most European companies rely on their local or regional banks and have no access to financing abroad, since the EU lacks a truly single capital market. At the same time, a potential economic downturn in a given region may seriously hit banks in that region, since their loan portfolios are often heavily concentrated on the local or regional economy. This is not just a theoretical model but a mechanism that has been observed in Germany in recent years, especially during the recent economic slowdown [Dullien and Schwarzer 2005].

(2) a European unemployment insurance system. Through this mechanism, a portion of social security contributions on wages that are collected by the member states to enable them to pay out unemployment benefits could be collected at the EU level. A European system, limited to a term of one year, would guarantee only a minimum level of unemployment insurance, and the member states would be free to provide additional benefits, with the level of benefits based on the level of previously earned income.

According to these authors, it is important to create a European stabilization mechanism with regional automatic stabilizers because some euro-area members, including Germany and the Netherlands, have been experiencing prolonged problems in getting back to their potential growth tracks after the recent economic slowdown. In the absence of a European stabilization mechanism countries or regions hit by severe economic downturns may experience high and persistent unemployment. Finally, noting that the above proposal would have no impact on the level of budget deficits in the euro-area countries, the authors argue "there is no reason to anticipate the financial markets being jeopardized by any resulting changes" and "a transfer aimed at cyclical stabilization might push down risk premiums on euro securities even further, leading to lower long-term interest rates; this in turn should help consolidate growth in Europe" [Dullien and Schwarzer 2005].

The problem of persistent regional unemployment has been observed in the euro area for many years. For example, analyzing data for 2000–2005, there are many regions in eastern Germany, southern Italy, southern Spain, and overseas departments in France, where unemployment rates have remained at very high levels, reaching twice or even three times the euro-area average, in upturns as well as downturns (see Figure 7). Regional unemployment rates in the euro area ranged from 2.7 percent to 30.1 percent in 2005 [Eurostat 2006]. Some authors argue that the reason for such regional asymmetries is the presence of a wage floor in the poorer and less productive regions, as a result of overly centralized labor market institutions. National unemployment compensation systems in the EU member states provide uniform benefits across regions within a given country, regardless of interregional productivity differentials, which may be large. These authors argue that such a mechanism tends to cause aggregate unemployment to be inflated by region-specific idiosyncratic shocks that increase inequality. In general, a wage floor in the less productive regions might turn them into regions of high unemployment; therefore, it is particularly important for EMU that centralization of labor market institutions at the European level, such as a "social snake" or "corridor model" for EU social policy, be avoided. Instead, effective regional policies should be deployed to combat idiosyncratic, and inequality-increasing, shocks [Pench, Sestito and Frontini 1999]. Although this view argues against undertaking some labor-market actions at the European level, it is not in contradiction with the proposal to establish an unemployment insurance system at the supranational level.

Another proposal, made last year, would require centralizing a significant part of national budgets at the euro-area level. [De Grauwe 2006a,b]. It would work according to the classic rule that, in the event of an asymmetric economic shock, the central euro-area budget would be able to transfer sufficient funds to regions affected by such a shock, and to collect more taxes from regions unaffected by that shock. Such a transfer system should have a temporary character, and be used only in the case of asymmetric shocks; otherwise, if it were to become a system of permanent transfers from richer to poorer regions, it would likely be unpopular among rich countries, as they might perceive their membership in a monetary union as costly. Recognizing that fiscal transfers in centralized countries are usually sizeable and unconditional, De Grauwe argues that in the euro area "such an insurance mechanism does not have to be as large and unconditional as those that exist within centralized countries; it is important, however, as a mechanism of solidarity even if its size is limited" [De Grauwe 2006a]. Other authors agree that such mechanisms at the EU level would give Europe a more social component that is currently missing [Dullien and Schwarzer 2005].

In his papers, De Grauwe argues that a central budget (of course, of an appropriate size, that is, a sizeable and federal-like one) is an important stabilizing instrument, and the absence of such a budget in the euro area implies that no budgetary policy aimed at stabilizing the business cycle in EMU is available at the European level. To illustrate the importance of a central budget capable of fiscal stabilization, De Grauwe analyzes the contrast between the euro area and the United States in their responses to the recent global economic slowdown, which began in 2001. The United States allowed its budget deficit to increase significantly as a response to that recession. In the euro area, where there is no sizeable, federal-like central budget, the aggregate national budget balance of the euro-area members could, in theory, have worked in a similar stabilizing way, but, in practice, it did not respond to the economic downturn conditions as the United States did, because that would have meant breaching the 3-percent-of-GDP reference value imposed by the SGP (see Figure 4). Thus, the lack of a Union-wide fiscal policy in the euro area meant there was no mechanism capable of performing a stabilizing role at the European level, and that macroeconomic stabilization within EMU had to be, as, in fact, it currently is, pursued only by means of centralized monetary policy and national fiscal policies.

It seems, however, that, at least, in some official circles in the EU, this current situation is not perceived to be a problem. De Grauwe, who advocates for a system-wide fiscal policy in the euro area to serve as insurance against asymmetric shocks, also notes some counterarguments related to the so-called "Brussels-Frankfurt consensus." According this view, there is no need for a single fiscal policy in the euro area, for the following reasons:

- The best way to cope with asymmetric economic shocks in the euro area is to increase market flexibility and competition by completing structural reforms of product, labor, and financial markets, as stipulated in the Lisbon Strategy [see, for example, Issing 2004, Almunia 2007, Commission 2006d, 2007c].
- The euro-area members should use the SGP as an appropriate instrument to deal with asymmetric shocks that have a cyclical component: they should run national fiscal policies aimed at balanced budgets over the medium term, and this will ensure enough flexibility to allow their budget deficits to increase by up to 3 percent of GDP during an economic downturn [see, for example, Trichet 2003, Commission 2004d, 2005c, 2006c, 2006d].
- There is no need for a system-wide fiscal policy to stabilize the business cycle in the euro area, since the ECB's single monetary policy is appropriately set to ensure macroeconomic stability in EMU and to contribute to sustainable growth through its strong focus on price stability [see, for example, Bini Smaghi 2007].

Some authors question the above arguments, stating, with reference to the first two arguments, that the latest evidence suggests that the steps towards liberalization included in the Lisbon Strategy, and the extension of the scope for the national fiscal policies, will be insufficient to set "problem countries" like Germany and the Netherlands back on track towards growth after an economic downturn [Dullien and Schwarzer 2005]. For example, although structural reforms have a positive impact on growth in the long run, [Blanchard and Giavazzi 2003, Berger and Danninger 2006], they are not sufficient to stimulate the economy in the short or medium term. With reference to the third argument, De Grauwe states that the Brussels-Frankfurt consensus is based on two academic theories that he finds questionable: monetarist theory and real business cycle theory. According to these theories, most economic shocks are supply-side shocks, and therefore a central bank cannot do much to stabilize the economy; maintaining price stability is the best way a central bank can contribute to macroeconomic stability and growth.[16] De Grauwe seems to be unconvinced that these

[16] According to monetarist theory, a central bank can deal with demand shocks to only a limited extent in trying to stabilize output movements by stabilizing inflation, but supply shocks cannot be dealt with by monetary policy and/or fiscal policies. In general, if a central bank tries too hard to influence the economy in order to stabilize it, the most likely result will be higher inflation and higher output volatility. Similarly, according to real business cycle theory, assuming that the sources of economic cycles are changes in preferences and shocks in technology (supply-side shocks), a central bank can do very little to influence output movements; it can only minimizing the negative effects of economic shocks by maintaining low and stable inflation [De Grauwe 2006a,b; see also Bini Smaghi 2007].

theories are right; hence, he suggests an alternative OCA view, rooted in Keynesian and neo-Keynesian theories. According to these theories, economic shocks are mostly demand-side phenomena, caused by waves of optimism and pessimism among consumers and investors, who decide to buy/invest more during an upturn and less during a downturn. De Grauwe argues that "in the logic of these Keynesian ideas, a monetary union needs a central budgetary authority capable of offsetting the desire of consumers gripped by pessimism to increase their savings, by dissaving of the central government. In addition, to the extent that there are asymmetric developments in demand at the national level, the existence of an automatic redistributive mechanism through a centralized budget can be a powerful stabilizing force." [De Grauwe 2006a,b]. The ECB officials, however, argue that, because of rational expectations, there is a level above which the traditional Keynesian effects produced by an increase in public spending and resulting rise in deficits are more than offset by so-called "Ricardian" effects. This means that governments may lose more in terms of household and business confidence, through agents' increasing their savings and reducing consumption and business investment, than they gain in terms of Keynesian spending [Trichet 2003]. Moreover, in the opinion of these officials, some of the assumptions underlying the standard new-Keynesian theories, notably, rational expectations and the possession of full information by central banks, are too simplistic and therefore unrealistic [Bini Smaghi 2007]. In addition to these theoretical considerations, some authors assert that, in practice, the recent experience of the United States demonstrates that a Keynesian, demand-oriented policy does effectively produce output movements in the economy [Dullien and Schwarzer 2005].

All of the systems proposed above for the euro area are aimed at international risk-sharing among the members/regions of a monetary union in the event of serious economic disturbances. The economic literature also contains some alternative proposals of such risk-sharing. For example, in the 1990s, a proposal was put forth to establish so-called "macro markets" for hedging the risk of fluctuations in aggregate income, national income, or aggregate labor income. According to the proponent, such macro markets could be established for each country of the world, with securities markets where claims to countries' entire future outputs would be traded. Nations could use these markets to insure themselves against the prospect of a declining standard of living, relative poverty, or other negative results of economic shocks. The argument for such markets runs as follows: "by hedging such risks, these macro markets would allow the natural tendency for convergence of incomes to reduce inequality of incomes, by removing the shocks that disperse incomes; thus, the establishment of such markets might make significant progress, in the long run, toward equalizing wealth across nations, regions, and … individuals themselves" [Shiller 1993]. Some authors have considered international or intranational risk-sharing among consumers from different regions of a monetary union or a given country as consumption smoothing via capital markets and/or credit markets [Atkeson and Bayoumi 1993, Asdrubali et al. 1996, Athanasoulis and van Wincorp 1998]. Other authors, although regarding these ideas as interesting and as raising important questions about the potential possibility of more efficient global or regional risk-sharing, note many practical obstacles to their feasibility. In the case of macro markets for hedging the risk of income fluctuations, they note such problems as moral hazard (incentives for national governments to underreport output if the claims are indexed to GDP), enforcement problems, and limits to a country's ability to insure against fluctuations in the non-tradable component of its GDP [Obstfeld and Rogoff 1996]. In the case of consumption smoothing by capital/credit markets, it is argued that such risk-sharing would be possible only in a world of complete capital markets, where consumers could insure themselves against region-specific shocks by holding portfolios allowing for higher returns when personal incomes are low during a downturn in a given region. But, in practice, capital markets are incomplete, and consumption smoothing can be provided by fiscal transfers across regions [von Hagen 1998]. The proposals concerning international risk-sharing by macro or capital markets were made in mid-1990s, at roughly the same time as the proposals concerning the establishment of interregional fiscal transfers. In recent years, however, only the latter proposals have been raised again and discussed as a potential solution for the euro area in the future.

3

Summing up, the main economic argument in favor of a single fiscal policy in the euro area is that it would provide euro-area members with insurance against asymmetric shocks, in turn, ensuring macroeconomic stabilization within EMU, by establishing an interregional system of fiscal transfers within the euro area. Such a system of fiscal transfers might cause euro-area members to view their participation in EMU as less costly than remaining outside EMU, where they would have to neutralize adverse shocks without financial support from abroad. This idea was first mentioned in the 1970s (Werner Plan, MacDougall Report), discussed in detail in the 1990s, and reactivated in recent years after some years of practical experience with EMU. In the past, the idea was often criticized, considered unnecessary, and finally abandoned. Thus far, however, no sustainable, viable alternative for a single fiscal policy in the euro area has been proposed. And the arguments in support of the view that the current EU framework for coordinating economic/fiscal policies is sufficient to maintain fiscal discipline and cope with economic shocks do not seem convincing in light of the long list of its weaknesses. Furthermore, the SGP, even in its reformed state, seems to be a temporary, rather than an ultimate solution for the euro area. The present framework seems to be quite good for the "infant" phase of EMU, but inadequate for its more "mature" stages. In contrast, the arguments in favor of a single fiscal policy in the euro area seem reasonable-in particular, the need to formulate an aggregate fiscal stance for the entire euro area in order to ensure sustainable macroeconomic stabilization within the Union and to provide insurance against asymmetric shocks-especially given empirical evidence suggesting that the euro area would be unable to use other adjustment mechanisms, such as labor mobility or wage/price flexibility, effectively to cushion the negative effects of asymmetric country- or region-specific shocks. Thus, some regions could suffer prolonged periods of sluggish growth and high unemployment, producing serious pressure on the euro area. While some argue that the strong business cycle synchronization among the euro-area countries and their high real convergence can reduce the probability of asymmetric shocks within EMU, although not eliminating them entirely, a more detailed analysis shows that asymmetric shocks do not seem to be a rare and negligible phenomenon in the euro area, nor created by external phenomena, but rather fairly frequent and created by the members of the euro area themselves through unilateral decisions of their governments, which have spillover effects on other EMU countries. Hence, it seems likely that, in the future, as in the recent past, the euro area will experience both symmetric economic shocks, mainly of an external origin, and asymmetric shocks, mainly of an internal origin. Therefore, the euro area as a whole should establish effective adjustment mechanisms to neutralize the negative effects of asymmetric shocks. So, perhaps it is worth reconsidering a single fiscal/ economic policy in the euro area, especially given that such policies, based on fiscal federalism, have proven successful in many countries of the world. But even the most reasonable economic arguments cannot make a single fiscal policy a reality in the euro area; the political will of the member states is a prerequisite.

4

Institutional and budgetary aspects of a single fiscal policy in the euro area

In assessing the feasibility of a single fiscal policy in the euro area, it is important to take into account some relevant institutional considerations, because the SGP, as the key element of fiscal policy coordination within the euro area, is viewed as an instrument built on a rather poor institutional foundation.

With respect to the institutional aspects of a single fiscal policy, a key issue is the need for a strong and effective executive authority at the supranational level. This is not a new idea. In the early 1970s, the Werner Plan postulated establishing not only a "Community system for the central banks," but also a "decision-making centre for economic policy" [Commission 1970]. Also, in 1998, just before the launch of EMU, it was argued that adopting a European common currency represented a decisive step for the participating member states towards closer integration and that, despite different preferences among countries, a more centralized policy might become not only possible but also necessary in the longer run, resulting eventually in the creation of a central fiscal authority for EMU [Cangiano and Mottu 1998]. Some years later, German Minister Fischer proposed establishing a European executive or government, and French Prime Minister Jospin proposed the creation of an economic government for the euro area. The European Commission stated that it is natural for governments and national parliaments to have formal roles and clear divisions of responsibilities in the formulation and implementation of economic policy and that a similar situation should also be observed at the European level [Commission 2002a]. This idea has not been forgotten and even today there are proposals to establish-after a sufficient degree of political unification has been achieved within the euro area-a central European government with real powers related to budgetary spending and taxation, independent of national governments and with the ability to complement the ECB's role in macroeconomic management of the euro area [De Grauwe 2006a]. This is important in the context of the need for a clearly defined aggregate policy stance in the euro area as a whole [Jacquet and Pisani-Ferry 2001], because having such an authority that could define an aggregate fiscal policy stance for the euro area would allow the ECB to set interest rates at the appropriate level for the entire area and would allow optimizing the overall policy mix in the euro area [Collignon 2001].

As some authors point out, establishing a strong political authority at the supranational level and delegating to it substantial national powers would require incorporating effective democratic control mechanisms to ensure that voters' legitimacy concerns are met [Enderlein et al. 2005]. This seems to be a relatively serious problem for the EU or the euro area in light of its "democratic deficit." Although it is sometimes argued that democratic representation and legitimacy could be ensured by the European Parliament, whose members are elected directly by voters in the member states, in fact, the European Parliament is not perceived by EU citizens to be an institution that truly represents their interests but rather as just another institution of the EU bureaucracy. Thus, the European Parliament in its present form does not seem to be a relevant institution that could actually supervise a supranational European body responsible for a single fiscal policy in the euro area. The problem is that there is no other democratically elected institution in the EU or the euro area. Thus, it seems that the only possibility would be a serious reform of the European Parliament, but that would require reforming the whole EU institutional framework, and making it more similar to those in federal countries like the United States.

Establishing a supranational economic government or central fiscal authority could bring numerous benefits for the euro area. These include:

- Ending the present imbalance between centralized monetary policy and decentralized economic/fiscal policies within EMU;
- Ending the present institutional imbalance within EMU (that is, creating a real counterpart for the ECB);
- Ensuring more macroeconomic stabilization in the euro area, especially in the case of asymmetric shocks within EMU;
- Eliminating excessive and harmful tax competition between the member states, which may lead to sub-optimal levels of public goods and services;
- Unifying the external representation of the euro area.

With reference to the last benefit listed above, it should be noted that an economic government could ensure a single and legitimate voice of the euro area in various international forums (IMF, G-7), thereby enabling the euro area to present a unified face (or speak with one voice) to the rest of the world. This is of utmost importance, because as long as the euro area is perceived as a group of more or less integrated countries, its importance will be assessed, at least, to some extent, on the basis of the importance of its individual member states. In the future, if and when the euro area starts to be regarded as a genuine single economic entity, its importance at the international level will increase significantly, matching its huge economic potential. At the moment, the EU, and the euro area, has been called an "accidental player" in international relations [Coeuré and Pisani-Ferry 2003, Pisani-Ferry 2005], or even an "economic giant" and a "political dwarf." Ensuring genuine representation of the euro area in international forums would be a very important, but not the only needed step towards its becoming an economic and political giant comparable to the United States [Szeląg 2007]. But the question of international representation for the euro area remains *de facto* unsettled [Commission 2002d]. Although the European Commission recently stated that several steps have been taken since last year to improve the external representation of the euro area, it agreed that further steps are needed before the external representation of the euro-area is commensurate with its growing weight in the global economy [Commission 2007b].

In considering a single fiscal policy, it is important to analyze its potential consequences for the EU budget. In this context some fundamental issues must be addressed:

- Is it desirable and feasible to increase the size of the EU budget significantly?
- Is it desirable and feasible to shift some national fiscal authority to the EU level, on both the revenue and expenditure sides?
- Is it desirable and feasible to introduce EU-wide taxes?
- What areas could potentially be financed from the EU central budget, if that budget were increased sufficiently?

The idea of increasing the EU general budget significantly is not new. In the 1970s, the MacDougall Report [Commission 1977] assumed a gradual, but substantial, increase in the Community budget, leading finally to a budget comparable with those in some federal countries. The report proposed three stages:

(1) a "pre-federal" budget, equal to about 2–2.5 percent of the Community's GDP;
(2) an "early-federal" budget, equal to about 5–7 percent of the Community's GDP;
(3) a "federal" budget, equal to about 20–25 percent of the Community's GDP.

That proposal, being too far-reaching, has not been put into practice, and the general budget of the EU remains very small, particularly in relation to the EU's economic potential (the EU budget is slightly over 1 percent of EU GNI).[17] The EU budget is also small in relation to the budgets of the individual member states; for example, it is about one-

[17] According to the EU Financial Perspective 2007–2013, the ceilings for own resources have been maintained at their current levels of 1.31 percent of EU GNI (gross national income) for appropriations for commitments, and 1.24 percent of EU GNI for appropriations for payments [Commission 2004b, 2004c].

tenth the size of the German budget (see Figure 8). Similarly, the EU general budget relative to national income is much smaller-about one-twentieth the size-in comparison with the U.S. federal budget, which amounts to about 20 percent of U.S. GDP. Some authors argue that a hypothetical European Federation should have budgetary powers comparable to those in the United States, but they add that while such "an almost twentyfold increase in the EU's spending power might strengthen the legitimacy and effectiveness of European governance, … it is inconceivable that the member states would agree to such an enormous decline in their revenues" [Börzel and Risse 2000]. It is also argued that "there can be no doubt that it would be a good thing, for the Union, to have more room for maneuver in the area of budgetary policy. But … no country has ever adopted a large budget just in an effort to obtain more instruments for economic policy. Historically, the size of the budgets grew because the functions attributed to the Union grew." [Padoa-Schioppa 2002]. With reference to this statement, it should be noted that recently, under the Financial Perspective of 2007–2013, the size of the EU budget has not been amended at all, despite the fact that some new priorities have emerged in recent years, notably promoting the EU's role as a global player. There have even been proposals to decrease the size of the EU budget. The European Commission stated that expecting more Europe for less money is simply unrealistic, since new policy areas at the EU level imply new financial requirements. Without sufficient financial resources, this will remain an empty promise [Commission 2004b, Prodi 2004]. The earliest opportunity to increase the EU budget to even the "pre-federal" size, would be in 2014–2018 or 2019–2023, in one of the next financial perspectives.[18] Of course, reaching this goal would require significant deepening of political integration within the EU in the current and forthcoming decades, as well as a gradual evolution of the EU towards a more federal structure.

A related issue is the structure of the EU general budget. The significant difference in size of the EU and U.S. budgets reflects their very different compositions in terms of both expenditures and revenues. As far as budgetary expenditures are concerned, three main functions of the budget are usually considered: allocation, redistribution, and stabilization. The U.S. budget performs all these functions, while the EU budget fulfils mainly the redistributive function, and the other functions to only a small extent. U.S. budgetary spending is concentrated primarily on welfare (social security, public health), military expenses (national defense, veterans' benefits), and education (see Figure 10). On the contrary, in the EU, spending on welfare, defense, and education is done at the national level, while the EU budget focuses primarily on a few policies with strong redistributive effects, that is, agricultural policy (subsidies for farmers) and regional policy (financial support for poorer regions), which amount to roughly 80 percent of the EU budget's expenditures (see Figure 10). Also, there is a significant difference between the EU and U.S. budgets with respect to budgetary revenues. The U.S. budget is based mostly on personal and corporate taxes, as well as social security and retirement receipts (altogether representing more than 90 percent of U.S. federal budget revenues), while the EU budget relies mainly on national contributions of the members' states, notably, a share of the VAT base of each member state and a contribution from the member states based on their GNI, altogether representing more than 85 percent of the EU's budget revenues) (see Figure 11). Last but not least, the EU has no power to create or levy taxes, although it is quite active in harmonizing taxation within the Single Market.

The fundamental difference between the EU and U.S. budgets stems from the fact that the United States, unlike the EU or the euro area, is a federation, and its fiscal policy is based on fiscal federalism. According to the theory of fiscal federalism, in the absence of significant externalities, cross-border spillovers, and economies of scale, spending policies

[18] The Commission suggested that from 2013 onwards the financial perspectives should be established for periods of five years (instead of the seven-year periods currently). This schedule would be better a better fit with the institutional framework and schedule, because both the Commission and Parliament have five-year terms [Commission 2004c].

should be conducted at the lowest level of government possible in order to respond to local and regional needs. At the same time, taxation policies should be carried out at the highest level of government possible in order to reduce excessive and harmful tax competition between local/regional authorities [Gramlich and Wood 2000].

For many years, the EU budget has been regarded as a historical relic,[19] since almost half of its spending is still directed to a sector with declining economic significance (agriculture), and it has been financed mostly via national contributions linked to the national treasuries, rather than by taxes levied on an EU-wide basis [Sapir et al. 2003]. It is also argued that agricultural and regional policies, which are the EU's main expenditures, may be regarded as public goods benefiting the EU as a whole only to a limited extent [Enderlein et al. 2005]. Thus, it would be useful to identify EU-wide public goods that could potentially be financed by the EU central budget in the future, if the central budget were increased substantially. Opinions on this seem partly divergent and partly convergent. On the one hand, some argue that most public goods are of a regional nature and that therefore their provision would be better addressed at the national or regional levels rather than at the EU level [Costello 1993b, von Hagen 1993]. On the other hand, others argue that with the establishment of EMU, the spatial characteristics of public goods are likely to change over time. Given the growing unity among the euro-area member states resulting from their strengthening economic, monetary, and political integration, the spatial incidence of public goods may widen, preferences may become more uniform, and new European public goods may emerge. The provision of such goods should be centralized or very closely coordinated, regulated, and supported by financial transfers [Cangiano and Mottu 1998, Commission 1993]. Many European public goods and services have already been identified, including defense, security, foreign policy, environmental protection, energy, higher education, research and development (R&D), telecommunications, and transportation [CEPR 1993, Masson 2000].

According to some authors, "the EU fits naturally into federalism orthodoxy regarding spending policies," but in practice, "the EU does not have spending programs in many of the areas that would normally be contemplated for the central government in longer-standing federations" [Gramlich and Wood 2000]. In the opinion of these authors, such public goods as primary education, police and fire protection, and local roads, which are currently provided by national governments in the EU, should remain at the national level of government. But public goods like national defense and inter-country highways (the trans-European transportation network) should be shifted to the centralized European level in the future. This division of governmental responsibilities should evolve naturally as a result of the growing role of the EU in the area of common foreign and security policy, as well as from proposals to create an independent European defense system or a single European nuclear authority to speak for the EU as a whole in negotiations with other nuclear powers. It would suggest a gradually increasing role of a central European government in providing standard public goods over time. Such centralized efforts would need to be properly reflected in the expenditures of the European central budget. Finally, with reference to the concern that a shift of some current functions to the supranational European level may leave a vacuum at the national level, Gramlich and Wood argue that there were similar concerns related to the states of the United States, but they proved to be unfounded.

More recently, the European Commission has given many examples of public goods that should be financed at the supranational EU level: public health, food safety, consumer protection, education and training, R&D, infrastructure, the fight against organized crime

[19] Sometimes, it is argued that the current EU budget resembles the U.S. federal budget in the 19th century. First, the size of the U.S. budget was very limited at that time (about 2 percent of GDP until the Civil War in the 1860s). Next, expenditures were devoted mainly to financing a few projects or areas, such as public works, defense, and government agencies' operations). Finally, there were no federal income taxes, and the major source of the U.S. federal budget (about 80–90 percent of federal revenues) remained tariffs [Wallis 2000, Schick 2000, Enderlein et al. 2005].

and terrorism, immigration and asylum policy, and external relations and operations. The Commission added that uncoordinated spending at the national level to reach common European objectives is simply a waste of money [Commission 2004b]. Similarly, the Sapir Report called for a radical restructuring of the EU budget to focus on spending on those economic and social areas where it is best able to make a contribution to growth and solidarity in Europe, and suggested regrouping the EU budget's spending into the following categories:

- Growth fund (about 45 percent of the budget), including expenditures for R&D, education, training and infrastructure. Resources for growth should be allocated on a competitive basis.
- Convergence fund (about 35 percent of the budget), including financial assistance for low-income countries to support their catching-up processes. Resources for convergence should be allocated to countries on the basis of their income level.
- Economic restructuring fund (about 20 percent of the budget), including mainly aid to the agricultural sector and displaced workers. Resources for restructuring should be allocated to individuals anywhere in the EU, based on their economic conditions [Sapir et al. 2003].

This recommended structure of the EU budget implies a large increase in investment in areas that promote economic growth, especially knowledge and innovation, in line with the Lisbon Strategy,[20] and a very sizeable reduction in the share devoted to agriculture. But, in practice, while some of the EU member states, notably the United Kingdom, have called for a more rational structure of the EU budget in the future (lower spending on agriculture, higher spending on pro-growth and solidarity priorities), others, especially France, have wanted to maintain the budgetary status quo, mainly, with respect to substantial spending on agriculture. As a result, under the Financial Perspective 2007–2013, the budget structure has been amended to some extent, but only slightly, and has certainly not been restructured radically.

Although currently the EU has no power to create or levy taxes, there have been proposals to introduce EU-wide taxes. The most popular suggestion is to create an EU-wide environmental tax (eco-tax). It seems to be justifiable, because environmental protection and its externalities clearly have an international dimension. Moreover, national eco-taxes are generally unpopular and underdeveloped in the EU member states as a result of harmful internal tax competition within the Union [Spahn 1993, Tanzi 1996, OECD 1998]. There are also other proposals of EU-wide taxes in the economic literature. As mentioned above, some authors propose establishing a European corporate tax scheme [Dullien and Schwarzer 2005]. Others, for example, the authors of the Sapir Report, advocate reduction of the relative weight of national contributions to the EU budget, in favor of revenue sources with a clear EU dimension, arguing that further economic integration in the EU is likely to increase the number of sources that could accrue directly to the EU budget. In opinion of these authors, revenues directly accruing to the EU budget might be either related to a given EU policy (for example, the seignorage earned from issuing euro banknotes), or have a very mobile tax base within the EU (for example, capital income taxes or stock exchange taxes) [Sapir et al. 2003]. But other authors argue that, given the present state of political integration in the EU, it seems doubtful that such a proposal would be accepted. In their

[20] If spending on R&D were part of the biggest fund of the restructured EU budget, it would be more likely that the Barcelona target of 3 percent of GDP for R&D spending (of which ⅔ should be financed by the private sector, and ⅓ by the public sector) would be reached in the future-although surely beyond the Lisbon horizon. At the moment, spending on R&D in the EU and in the euro area amounts to 1.9 percent of GDP (see Figure 9), of which public expenditures are about 0.7–0.8% of GDP. This European indicator of 1.9 percent of GDP, which has remained unchanged since 1999 in the cases of both the EU and the euro area, is compared with around 2.7 percent of GDP in the United States. The EU also needs to step up its investment in higher education. It should be aimed at devoting at least 2 percent of GDP to higher education by 2010. The EU currently spends only about 1.3 percent of GDP on higher education, compared with about 3.2 percent in the United States (the gap is mainly due to greater private funding in the U.S.) [Commission 2005b].

opinion, the well-known principle "no taxation without representation" is still likely to be raised as an argument against any EU-wide taxes. And although such taxes could enhance the transparency of the EU citizens' contributions to the Union, national governments seem very reluctant to move the current EU revenue system in a more supranational direction that would eventually provide the EU with resources that could not be redirected to the member states (as is currently the case under the so-called "juste retour" principle) [Enderlein et al. 2005, see also Menédez 2000].

As mentioned above, according to the theory of fiscal federalism, taxation policies should be carried out to a large extent at the highest level of government (central/federal government)-to reduce harmful tax competition at the lower (local/regional) level of government. This is the case of the United States but the EU, in order to reduce tax competition, has taken the alternative approach which is harmonizing and coordinating national taxation systems and policies. The theory of fiscal federalism suggests that taxes on mobile factors, such as corporate taxes, value added taxes (VAT), and capital income taxes, should be harmonized, whereas there is no need to harmonize taxes on immobile factors, such as labor.[21] However, the theory of fiscal federalism does not regard harmonization and coordination of taxation as the best solution. The best option is to have full centralization of taxes on mobile factors such as capital, which is mobile enough for tax competition and tax evasion. In the case of immobile factors, such as labor, some authors argue that-although currently there is less labor mobility within the EU (or the euro area) than in countries with federal structures such as the United States, Canada, or Australia (and this is the reason that allows many European governments setting labor income taxes and unemployment benefits more freely than otherwise)-labor mobility among the EU member states will probably increase over time, making a centralized setting of tax rates on labor income potentially more desirable in the future [Gramlich and Wood 2000].

4

Turning from theory to practice, the question arises as to which of various possible existing fiscal federations could serve as a reference or model for the EU in planning its potential fiscal federalism. The most popular examples are German co-operative or intra-state federalism, which is based on shared fiscal powers of the federation and lands, including a joint taxation system that allows for sharing the most important taxes between the two levels of government; and the U.S. dual or inter-state federalism, which is based on a division of fiscal powers between the federation and the states, and widespread fiscal autonomy of the states, which are allowed to levy taxes as their independent revenue source. According to some authors, the German model of fiscal federalism is unlikely to be replicable in the EU, and therefore, the U.S. model, which would allow for a weaker European federation than would the German model, seems to be more appropriate for the EU or the euro area. But these authors recognize that "while the U.S. model might appeal to those afraid of a strong European federal state, the emerging European federation has, so far, evolved along the lines of shared, rather than a divided, sovereignty" [Börzel and Risse 2000].

Finally, establishing a single fiscal policy in the euro area would require not only increasing the size of the EU general budget and changing its structure. Other fundamental changes related to the present characteristics of the EU budget would also be required [Szeląg 2003, 2004, 2007], namely:

- Abandoning the present rule stipulating that revenues and expenditures shown in the budget must be in balance for each financial year, and permitting fiscal surpluses or deficits;

[21] The process of coordinating and harmonizing taxation in the EU is related especially to indirect taxes. The Treaty calls for harmonization of turnover taxes, excise duties, and other forms of indirect taxation. And, indeed, there has been substantial progress in this area, notably in the case of VAT and excise duties, which have been harmonized to the greatest extent, achieving also a partial alignment in the rates among the member states. In the case of direct taxes, the Treaty does not specifically call for their harmonization, but only for the approximate equivalence of laws in those areas where they affect free movement of goods and freedom to provide services. Nevertheless, there are visible effects of this voluntary harmonization of direct taxes, mainly in the area of corporate taxation.

- Providing the EU, or, more precisely, its "central fiscal authority," the right to borrow the necessary financial means to finance its budget deficit, although obviously not from the ECB or other central banks.

It should be emphasized that the above proposal does not mean that the EU or the euro area would automatically shift from the current situation of relatively low budget deficits to an undesirable state of running permanently high deficits. It seems that even if the EU were allowed to run fiscal deficits, the general principle of the SGP concerning the medium-term budgetary objective of keeping the budget "close to balance or in surplus" could be maintained. Moreover, it seems that a single fiscal policy at the European level would be more cautious than some expansionary fiscal policies conducted at the national level in the euro area. The reason for this is that the EU is fully aware of the economic and budgetary consequences it faces as a result of aging populations (an expected enormous strain on public finances and labor supply, which could significantly affect the EU's outlook for growth and employment), and the European Commission continually calls for fiscal consolidation in the member states, since otherwise the projected debt dynamics would worsen considerably in the long run. Therefore, it seems that a European central fiscal authority would follow the path of budgetary consolidation as well, and, although allowed to run deficits, would usually try to keep the EU general budget close to balance or in surplus, avoiding an "excessive deficit." But in exceptional circumstances like the recent global slowdown, it would have more room for maneuver to respond appropriately, together with the ECB,[22] to unfavorable economic conditions. This would most likely mean a temporarily higher or even excessive EU budget deficit during a downturn, but it would help to avoid a prolonged period of sluggish growth or even stagnation and would facilitate a return of the EU economy towards its potential growth track. Of course, any excessive deficit would need to be corrected relatively soon after convincing signs of a sustainable recovery were evident. In this case, another EU principle-prohibition of monetary financing of budget deficits-would be fully respected as well. Therefore, the above idea, although new, has some elements of continuity with the present EU rules.

In sum, the successful establishment of a single fiscal policy in the euro area depends on many conditions-not only economic and political conditions, but also institutional and budgetary ones. It would require establishing an economic government or central fiscal authority in the euro area, as well as significantly increasing and restructuring the EU budget. In other words, it would mean introducing fiscal federalism in the euro area. It seems that establishing such a supranational economic government could bring numerous benefits for the euro area, including both internal benefits, such as eliminating excessive and harmful tax competition between the member states, and external benefits, including ensuring unitary external representation of the euro area in the world. Of course, such

[22] This discussion relates to the discussion on the ECB's responsibility and the advisability of extending it beyond focusing only on controlling inflation-similarly to the mandate of the central bank in the United States. As is known, the Maastricht Treaty stated that the primary objective of the ECB is to maintain price stability, but at the same time, without prejudice to this objective, the ECB should support the EU's general economic policies in order to contribute to the achievement of the EU objectives, including, among others, sustainable and non-inflationary growth, and a high level of employment and of social protection. However, some authors complain that "the ECB has filled out the fine print of its mandate by essentially dropping the requirement that it should pursue other objectives than price stability" and "the ECB has absolved itself from any responsibility about unemployment; it has relegated this responsibility to the national governments" [De Grauwe 2006b]. In the United States, according to the Federal Reserve Act as amended by the Humphrey-Hawkins Full Employment Act of 1978, the central bank, or, more specifically, the Board of Governors of the Federal Reserve System and the Federal Open Market Committee, is obliged to "maintain long-run growth of the monetary and credit aggregates commensurate with the economy's long-run potential to increase production, so as to promote effectively the goals of maximum employment, stable prices, and moderate long-term interest rates" (Federal Reserve Act, Section 2A). The U.S. experience shows that it does not violate the principle of central bank independence, and makes the central bank (an institution with huge potential, power, and independence) co-responsible, together with the federal government, for the whole economy, and not just for its narrow, although very important, part. It seems that the same approach should be considered in the case of the euro area, regardless of whether it evolves over time towards a more federal structure.

fundamental changes to the present institutional and budgetary framework could not be introduced at once; it would require a gradual approach as in the case of EMU, which has been implemented stage by stage. Moreover, it seems that the proposed changes would likely involve broader reform of the present institutional setup of the EU than was the case with EMU. For example, the economic government might be created on the basis of some existing structures, notably the European Commission, whose powers related to economic/fiscal policy could be extended gradually over time. Obviously, the Commission would have to share its new power to some extent with, for example, the Eurogroup or the European Parliament, by consulting them and even seeking their approval while setting the aggregate fiscal stance for the euro area or the revenue and expenditure ceilings for the EU budget. Moreover, providing the Commission with such great budgetary power would necessitate ensuring democratic control over its activity. It seems that such control could potentially be exercised by the European Parliament if the Parliament were reformed fundamentally to become more similar to the U.S. Congress. Finally, establishing an economic government, presumably based on the European Commission's structures and controlled by a reformed European Parliament, would mean not only reforming the EU institutional architecture, but also ensuring proper relations between these new or reformed EU institutions and national governments and parliaments in order to ensure their appropriate participation in the supranational budgetary procedures and fiscal policy. A single fiscal policy does not mean that the member states would be marginalized; on the contrary, it would stipulate their active participation. Finally, it should be emphasized once again that the absolutely indispensable ingredient needed to make a single fiscal policy in the euro area a reality is the political will of the EU member states, including the will and the follow-thorough to implement a political union among themselves in the future. Therefore, it is worth analyzing in greater detail the current stage of the political debate on the future of Europe.

5

The political debate on the future of Europe

The proposal to establish a single fiscal policy in the euro area is undoubtedly far reaching. It is argued that such far-reaching reform proposals could increase the efficiency and legitimacy of the EU budgetary framework and procedures, but that they would require a much higher degree of political integration than is currently the case in the EU [Enderlein et al. 2005]. Some authors even argue that the current problems relating to economic governance in the euro area call for further steps towards a political union[23] because without one the euro area and EMU are at risk of collapse [De Grauwe 2006b]. Furthermore, other authors, despite having stated that the hope of a European political union seems less and less realistic every day, emphasize that "without serious, deep, and comprehensive reforms Europe will inexorably decline, both economically and politically" [Alesina and Giavazzi 2006].

Even in the early years of EMU, some U.S. authors, having deemed that the EU represents an interesting case study for examining some of the postulates of fiscal federalism, noted that "in some areas the EU has already developed arrangements that fit standard views of fiscal federalism, in other areas there is gradual movement toward prescribed arrangements, and in still other areas the EU's unique historical path may suggest some interesting new departures in the federalism literature" [Gramlich and Wood 2000]. Although neither the EU nor the euro area, is a federation and neither has adopted a federal approach to fiscal policy, some European officials argue that "the solution put forward in Europe includes a mutual surveillance aspect, which goes far beyond the policy framework implemented in mature federal organizations, such as the United States, Germany, and Switzerland. In the American states, the German Länder, and the Swiss cantons, fiscal decisions are made in a more decentralized institutional framework" [Trichet 2003]. The important issue, however, seems not to be which framework is more or less centralized, or more or less comprehensive, but simply which one is more or less effective.

The issue of further political integration in Europe has been widely discussed in recent years. In the debate on the future of the EU and EMU prompted by the introduction of the euro, there are two contrasting views: (1) the present degree of political unification in the EU is sufficient to ensure the long-term survival of EMU, and (2) EMU cannot survive in the long run without a strong political union of the member states.

The debate on the political future of Europe began with the famous speech of Fischer, German Minister of Foreign Affairs at that time, held at Humboldt University in Berlin in May 2000 [Fischer 2000]. He proposed a transition from a union of states to a European Federation (something Schuman and Monnet, the fathers of European integration, had demanded in the 1940s and 1950s) with truly federal institutions, such as a real European Parliament consisting of two chambers and a European government,[24]

[23] It should be noted that there is no common definition of a "political union" in the literature. Usually, however, a political union is understood to be a type of state or organization, consisting of a given number of countries (or states, lands, or other administrative units), which, in addition to their national/regional/local authorities, have a common, supranational government, with the union as a whole recognized as a single political and economic entity in the world. For more details about the process of European political unification, political economy of European monetary integration, connections between a monetary and political union, see (for example) Eichengreen 1997, Eichengreen and Frieden 2000, and Wallace, Wallace, and Pollack 2005.

[24] According to Fischer, there are two main options for forming such a government: (i) developing the European Council into the European government, or (ii) taking the existing structure of the European Commission as a starting point (in this case, one can opt for the direct election of its president with far-reaching executive powers).

institutions that could actually exercise their legislative and executive powers within the Federation. The Federation would have to be based on a constituent treaty or European Constitution. The idea of a European Federation would imply the necessity of transferring some further national powers and sovereignty to the European level. But it should be stated clearly that a European Federation would mean neither the abolition of the nation states and their national governments nor their replacement by the newly created European superstructures. Nevertheless, in May 2001, Jospin, then French Prime Minister, rejected the idea of transforming the EU into a European Federation and supported the idea of a "Federation of Nation States," the term originally coined by Delors, former President of the European Commission (in the 1980s and 1990s). The Federation of Nation States was intended by Jospin to be a loose confederation rather than a real federation. Surprisingly, however, he also suggested establishing an "economic government for the euro area" to balance the structure of the Union, as well as setting up a short-term economic action fund, to which individual member states would be given access in case of economic shocks and world turbulence [Jospin 2001]. Shortly after Jospin's speech, Blair, British Prime Minister at that time, presented his position on the future of the EU. He rejected some crucial elements of both German and French visions of Europe: the German proposal for a more federal Europe and the French proposal to harmonize corporate taxes across Europe. Moreover, even the initiator of the debate, Fischer, has recently begun to emphasize at Harvard University and Boston University that the future EU cannot be a "federal superstate" and must be based on the existing nation states [Fischer 2006, 2007]. Some constitutionalists considered whether the future EU could be a federation but not a federal state, as Fischer's speech of 2000 seemed to suggest [Leben 2000]. In general, it seems quite clear that there is no common vision in Europe concerning the future of the EU or the euro area.

Fischer's speech received a lot of reactions, responses, and comments, not only from other European politicians but also from academic professors, researchers, and other professionals [see, for example, Joerges, Mény, and Weiler 2000]. In response to Fischer, and with reference to the subject of this paper, some authors [Börzel and Risse 2000] argued that his European Federation looked very much like the United States of Europe as proposed by former British Prime Minister Churchill in the 1940s, that is, a European federal state, which was clearly rejected by Fischer. In the opinion of these authors, the EU already constitutes an emerging federation or emerging federal system, since it shares most features attributed to federations in the literature [see, for example, Burgess 2000] and lacks only a few significant federal features. One omission is the lack of a real "tax and spend" capacity; in other words, there is no fiscal federalism in the EU. The authors regretted that this lack was not discussed in Fischer's speech,[25] because taxation and spending powers are vital to both the effectiveness and the legitimacy of every political system, so providing the EU with real legislative and executive powers seems useless without giving it the necessary financial resources to exercise these powers effectively. Moreover, they argued that the wide-ranging redistribution of social welfare at the EU level could foster the integration of European societies and increase the legitimacy of European institutions [Börzel and Risse 2000].

In order to institutionalize the debate on the future of Europe, the European Convention was established following the Laeken Declaration on the future of the EU, and was adopted by the European Council in mid-December 2001, about two weeks before the introduction into circulation of euro banknotes and coins. The Convention, chaired by Giscard d'Estaing, former President of France, wrote a draft Treaty establishing a Constitution for Europe. This Constitutional Treaty was to be a turning point in the process of European integration, but with respect to the policy mix within the EU, it stipulated maintaining the status quo, that is, maintaining the single monetary policy for the euro area formulated at the supranational level, with national economic, employment, and fiscal policies coordinated within the EU.

[25] Although, in fact, this issue was not discussed in Fischer's speech, it seems quite obvious, since he mentioned a "European government that could actually exercise its executive power," and it is hard to imagine this without real "tax and spend" powers of such a government.

In general, the new Treaty was seen by EU citizens as too complicated and not transparent, and, in the end, it was rejected in referendums in France and the Netherlands in May and June of 2005, respectively). These rejections stopped the whole process of ratification of the European Constitution, and the political debate on the future of Europe lost momentum among the EU leaders.

In June 2007, after the two-year "period of reflection" that provided the opportunity for wide public debate about the EU's future, the European Council stated that the original constitutional concept, which stipulated repealing all existing European Treaties and replacing them with a single text called "Constitution," was abandoned. Instead, it proposed drawing up the so-called "Reform Treaty" amending the existing Treaties.[26] Although the EU is to have a single legal personality (similar to unitary or federal countries), the European Council unambiguously stated that all terminology that might suggest that the EU is evolving towards a more federal model will be abandoned; for example, the term "Constitution" will not be used, the "Union Minister for Foreign Affairs" will be called "High Representative of the Union for Foreign Affairs and Security Policy," and there will be no article in the amended Treaties mentioning the symbols of the EU, such as the flag, the anthem, or the motto [European Council 2007].

Thus, regardless of how convincing the arguments in favor of an economic government or central fiscal authority in the EU or euro area, currently member states clearly lack the political will, social support, and readiness to transfer further authority from the national to the EU level. It should not be a surprise that there is strong opposition to a single economic/fiscal policy in the euro area, given that member states' ability to set economic policies, and especially their fiscal authority, have always been regarded as an indication of national sovereignty. This seems natural, in part because the euro-area member states yielded part of their sovereignty-their ability to set monetary and exchange rate policies-not long ago. Therefore, this situation is likely to remain unchanged in the near future. Some authors argue that "the recent 'no' votes concerning the European Constitution signal that there is a strong 'integration fatigue' in the EU today, making it unlikely that significant progress in political unification can be made. This will continue to make the eurozone a fragile regime. In the long run, however, there can be little doubt: without further steps towards political union the eurozone has little chance of survival" [De Grauwe 2006b]. Therefore, the idea of a single economic/fiscal policy in the euro area seems to be a longer-term vision. Although some believe that the institutional setup for supranational fiscal policy would have been desirable at an early stage of EMU [Buchanan and Musgrave 1999], it now seems more likely that the social context for a common fiscal policy will be considerably stronger 10 or 20 years after the introduction of the single currency and the single monetary policy [Masson 2000]. This raises the question whether, if the euro-area economic framework has so many shortcomings that make the euro area a rather fragile system, it is possible for EMU to survive for so long, for example, for 20 years. This seems not to be a real problem, however; EMU will survive because its abolishing, if feasible at all, would be enormously costly and would have unpredictable effects on the member states and the EU as a whole. And potential loss of prestige in the event of such a failure would also seem to be important. The key question is whether EMU will be maintained in its present, imperfect form, or not.

The political debate on the future of Europe is focused notably on whether the EU should remain a looser "confederation of nation states" or evolve over time towards a "European Federation." The former is desirable because it would provide the EMU member states with some control over the integration process but it is questionable whether it

[26] The "Reform Treaty" is expected to contain two substantive clauses amending the Treaty on the European Union and the Treaty establishing the European Community. The latter is to be called the "Treaty on the Functioning of the Union," since the EU will replace and succeed the European Community. Neither Treaty (as amended by the "Reform Treaty") will have a constitutional character, but they will together constitute the basis on which the EU is founded [European Council 2007].

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would ensure an optimal economic framework for the EU, especially with respect to the sharing of the single currency. The latter requires shifting some national powers to the supranational European level, and it is argued that it is worth this high price, because federations have proved their value as successful structures functioning in various regions of the world, including the most developed ones-such as America (the United States, Canada), Europe (Germany, Switzerland), or Australia. This is a simple, transparent and-last but not least-effective solution in terms of political, social, and economic dimensions. The federal structure has proven effective in situations with a varied number of states or countries, for example, 16 lands in Germany and 50 states in the United States (accordingly, it seems to be also suitable for the EU consisting of 30 member states or more). Of course, within the EU (or a hypothetical European Federation), the nation states would still exist and, given their strong national identities and huge cultural diversity, would retain a much larger role than the lands in Germany or the states in the United States. And, again, it should be stated as clearly as possible that the idea of a European Federation will mean neither the abolition of the nation states nor replacing them by the newly created "European superstructures".

Concluding remarks

The idea of a single fiscal policy in the euro area has been proposed in response to the numerous weaknesses of the EMU's present macroeconomic framework, which combines a single centralized monetary policy with decentralized national economic and fiscal policies-which does not seem to be an ultimate one in the long run. The arguments in favor of this idea seem reasonable, in particular, the need to formulate an aggregate fiscal stance for the euro area as a whole in order to ensure sustainable macroeconomic stabilization within EMU and to have a kind of insurance against asymmetric shocks. But in order to make this vision a reality, it is not enough to have reasonable economic, financial, or institutional arguments; the absolutely indispensable ingredient is the political will of the member states. It is also necessary to introduce some significant – even enormous – changes to the present political, institutional, and macroeconomic design of the EU, such as a full political union, federal structure and federal institutions, and fiscal federalism. Currently, there is neither the political will nor the social support in the EU for transferring further national authority to the supranational European level. It is often argued that it is impossible to transfer fiscal policy from the national to supranational level because such things as a national budget, and, in particular, national taxes, are aspects of national sovereignty. While it would be inadvisable to underestimate this argument, it should be recalled that a similar argument was often raised as a counterargument against the launch of EMU (and, in particular, against a single monetary policy in the euro area), but events have shown that this obstacle may be surmountable.

Therefore, turning back to the question in the title of this paper – is a single fiscal policy in the euro area a vision or utopia? – it seems quite obvious that nobody knows the right answer to this question at the present moment. Given the current political situation, notably, the recent "integration fatigue" in the EU, a single fiscal policy in the euro area appears utopian in the short and medium terms. But what about a single fiscal policy in the euro area in the long run? The question is whether the political will to achieve this will emerge in the future, or not. And, if so, when might it happen-in 10 years, 20 years, or perhaps 30 years? Nobody knows at the moment. Perhaps, before looking forward 20 to 30 years, it would be sensible to look backward 20 to 30 years and recall that, in the early 1970s, the Werner Plan was regarded by many people as utopian and its collapse seemed to prove them right. But after many years, at the beginning of 1990s, the political will re-emerged and efforts were revived. As a result, that utopian dream of the early 1970s became a reality by the end of 1990s and is our day-to-day reality in the 21st century. People like Werner are no longer called utopians but visionaries. But the political will that emerged in both the early 1970s and the 1990s, and fundamental decisions made at that time concerning the single currency and the single monetary policy were prompted by emergency situations regarded as threats to the process of European integration, including the improper functioning and finally the collapse of the Bretton Woods system and the serious crisis of the European Monetary System. It is likely that a similar spectacular crisis in the EU, or rather in the euro area, could prompt the EU leaders to make further fundamental decisions (related, for example, to a single fiscal policy in the euro area). The question is whether a severe economic or financial crisis is really a prerequisite for motivating politicians to make such decisions and inducing people to support them.

Annex: Boxes, tables and figures

Box 1: Key dates in the history of Economic and Monetary Union (EMU)

1969–1970	Barre Report on greater coordination of economic policies and monetary cooperation, Hague Summit, and Werner Report (or Werner Plan) on the attainment of economic and monetary union in the European Economic Community (in three stages)
1972	Basle Agreement of the Community central banks on the narrowing of the fluctuation bands between their currencies (the first Community exchange rate system-"snake in the tunnel")
early 1970s	The failure of the Werner Plan due to significant international monetary/economic turbulences (the collapse of the Bretton Woods system, the devaluations of the dollar, the first oil shock)
1979	The establishment of the European Monetary System-including the European Currency Unit (ECU) and the Exchange Rate Mechanism (ERM)
1989	Delors Report on economic and monetary union in the Community-to be attained by stages (the first stage decided to begin on July 1, 1990)
1990–1993	Stage One of EMU: liberalization of capital movements between the member states
1990–1991	Intergovernmental Conferences in Rome on political union and economic and monetary union
1991	Adoption of the Treaty on European Union by the Maastricht European Council-stipulating the launch of Economic and Monetary Union (EMU) and the introduction of the single currency (ECU) in the European Union on January 1, 1999, at the latest
1992–1993	The ERM crisis and the widening of the ERM fluctuation bands (from +/– 2.25% to +/–15%)
1993	The entry into force of the Maastricht Treaty (the second and third stages of EMU decided to begin on January 1, 1994, and January 1, 1999, at the latest, respectively)
1994–1998	Stage Two of EMU: achieving a high degree of economic convergence of the member states (fulfilling the so-called Maastricht convergence criteria), setting up the European Monetary Institute (EMI) responsible for strengthening monetary policy coordination
1995	Madrid European Council decided that the name of the single currency will be "the euro" (instead of the ECU) and outlined the currency changeover scenario ("Madrid scenario")
1997–1999	Strengthening coordination of economic and fiscal policies of the member states: adoption of the Stability and Growth Pact (1997), the Luxembourg process (1997), the Cardiff process (1998), and the Cologne process (1999)
1998	Establishing and organizing the European Central Bank (ECB) on the basis of the EMI
1999 onwards	Stage Three of EMU: the introduction of the euro in the 11 EU members states (EUR 1 = ECU 1), and the start of the single monetary policy in the euro area formulated by the ECB
1999–2001	The transitional period: the euro in a non-cash form only (in line with the "Madrid scenario")
2001	Greece joined the euro area as its 12th member
2002	The euro changeover: introducing euro notes and coins into circulation and withdrawing the national currencies (the euro as the only legal tender after the 2-month dual circulation period)
2005	Reform of the Stability and Growth Pact
2007	Slovenia joined the euro area as its 13th member
2008	Cyprus and Malta joined the euro area as its 14th and 15th members

Source: author's elaboration.

Box 2: An overview of key institutions and other bodies of the EU and EMU

According to the Treaty establishing the European Community (as amended by the Treaty on European Union-the so-called Maastricht Treaty), the tasks entrusted to the Community shall be carried out by the following institutions: Council, Parliament, Commission, Court of Justice, Court of Auditors.

Council (Council of the European Union): This is the main decision-making body of the EU. It consists of one minister from each of the EU's national governments. There are various configurations within the Council, for example: Economic and Financial Affairs Council **(ECOFIN Council)**, consisting of national Ministers of Finance/Economy. The Council has six key responsibilities: (1) passing European laws – jointly with the European Parliament in many policy areas, (2) coordinating the broad economic policies of the member states (BEPGs), (3) concluding international agreements between the EU and other countries or international organizations, (4) approving the EU budget-jointly with the European Parliament, (5) developing the EU's Common Foreign and Security Policy, based on guidelines set by the European Council, and (6) coordinating co-operation between the national courts and police forces in criminal matters. The Council Presidency rotates every six months. Decisions in the Council are made by voting (a country's number of votes depends on its population, for example: Germany and France have 29 votes each, and Malta has 3 votes out of total 345 votes). Usually, the Council makes decisions by qualified majority voting, but unanimity is required in some particularly sensitive areas (for example, taxation).

– The **Eurogroup** is an informal but important body in the euro area. Similar to the ECOFIN Council, the Eurogroup consists of Ministers of Finance/Economy, but from the euro-area member states only. Moreover, the Eurogroup is a consultative forum, while the ECOFIN Council is a decision-making body.

– The Heads of States or Governments (Presidents and/or Prime Ministers of the member states), together with the President of the European Commission, meet as the **European Council** (up to four times a year). These "summit meetings" set overall EU strategy and policy, and resolve issues that could not be settled at a lower level (by the ministers at regular Council meetings). The agreements made by the European Council are being included in the strategic document called "Presidency Conclusions".

Parliament (European Parliament): This institution is elected by the EU citizens to represent their interests. Elections are held every five years (since 1979, members have been directly elected by the people). The current Parliament has 785 members from all 27 EU countries, but this number is to be reduced to 736 from the next parliamentary term (2009–2014) onwards. Members of the European Parliament (MEPs) do not sit in national blocks, but in seven Europe-wide political groups (from the strongly pro-federalist to the openly Eurosceptic ones). The Parliament has three main roles: (1) passing European laws-jointly with the Council in many policy areas, (2) exercising democratic supervision over the other EU institutions, and in particular the Commission (it has the power to approve or reject the nomination of commissioners, and to censure the Commission as a whole), and (3) the power of the purse (adopting or rejecting the EU budget). The Parliament works in three places: Strasbourg (plenary sessions), Brussels (committee meetings), and Luxembourg (administrative offices).

Commission (European Commission): This is a supranational institution, independent from national governments, representing the interests of the EU as a whole. It is the executive arm of the EU, managing its day-to-day business. The Commission has four main roles: (1) proposing new legislation, (2) managing and implementing EU policies and the EU budget, (3) enforcing European law (jointly with the Court of Justice), and (4) representing the EU on the international stage (for example, by negotiating agreements between the EU and other countries). The Commission is appointed every five years and remains politically accountable to the European Parliament. Currently, it consists of 27 members (commissioners) from all the member states (this number is to be reduced since 2009 onwards). Its staff amounts to about 25,000 of civil servants. The seat of the Commission is located in Brussels, but it also has offices, representations, and delegations in many other cities around the world.

The Council, the Parliament, and the Commission, which were set up in the 1950s under the European founding treaties, constitute the so-called "institutional triangle" of the EU. They adopt the policies and laws that apply throughout the EU. In principle, the Commission proposes new laws, and the Council and Parliament adopt them (under the co-decision procedure).

The **Court of Justice**, established in 1952 and based in Luxembourg, is composed of one judge per member state, and its role is making sure that EU legislation is interpreted and applied in the same way in all the member states. The **Court of Auditors**, set up in 1975 and based in Luxembourg, is composed of one member from each EU country, and its main role is checking that the EU budget is correctly implemented. Both courts have some staff to help in conducting its day-to-day activities (in particular, the Court of First Instance, created in 1989, to support the Court of Justice).

In addition to its institutions, the EU has many other specialized, advisory and consultative bodies, such as, for example, the **European Economic and Social Committee** (representing civil society, employers and employees), and the **Committee of the Regions** (representing regional and local authorities). The committees, set up in 1957 and 1994 respectively, consist of 344 members from all the member states.

The key institution for EMU is the **European Central Bank** (ECB), established in 1998 and based in Frankfurt am Main. This is the central bank for Europe's single currency (the euro)-responsible for formulating the single monetary policy in the euro area (currently, there are 13 out of 27 EU members states belonging to the euro area, and in 2008, this number will be increased to 15). The ECB is the central element of both the Eurosystem (which it constitutes together with the euro-area central banks), and the European System of Central Banks (which it constitutes together with all the EU central banks). The primary objective of the ECB is maintaining price stability (and, without prejudice to this objective, it shall support the EU's general economic policies). The basic tasks of the ECB/Eurosystem/ESCB are the following: defining and implementing the single monetary policy for the euro area, conducting foreign exchange operations, holding and managing the official foreign reserves of the member states, promoting the smooth operation of payment systems, as well as contributing to the smooth conduct of policies pursued by the competent authorities relating to bank prudential supervision and financial stability. The main decision-making body of the ECB is the Governing Council, consisting of the six members of the Executive Board and the governors of the national central banks from the euro-area countries.

There are also some key committees for EMU – notably the **Economic Policy Committee** (EPC) and the **Economic and Financial Committee** (EFC), set up in 1974 and 1999 respectively. They consist of two members from each member state (usually senior officials from national ministries of finance/economy and central banks) and two members from the Commission and the ECB. The EPC's role is providing advice to the Council and Commission, and contributing to the preparation of the ECOFIN Council's work related to coordination of economic policies of the member states. In general, the EPC is asked to focus on structural policies for improving growth potential and employment in the EU in line with the Lisbon Strategy. In particular, it provides support for the Council in the formulation of the Broad Economic Policy Guidelines (BEPGs), the multilateral surveillance of the Lisbon National Reform Programs, the Macroeconomic Dialogue with social partners under the Cologne process, and the preparation of the Employment Guidelines (EGs) under the Luxembourg process. As far as the EFC is concerned, its role is making some preparatory works for the Council, including a review of the economic and financial situation of the member states, the exchange rate of the euro, and relations with third countries and international institutions. This advisory committee also provides the framework for preparing and pursuing the dialogue between the Council and the ECB.

Source: author's elaboration based on the Treaty on European Union, the EU websites (http://europa.eu/institutions/inst/index_en.htm, http://ec.europa.eu/economy_finance/epc/epc_en.htm, http://europa.eu/scadplus/leg/en/lvb/l25038.htm), and the ECB website (http://www.ecb.int).

Table 1
Effectiveness of federal/central budgets in absorbing adverse effects of asymmetric shocks*

Authors	United States		Canada		Germany		United Kingdom		France		Italy	
	R	S	R	S	R	S	R	S	R	S	R	S
MacDougall / Commission (1977)	28		32		29				54		47	
Sala-i-Martin and Sachs (1991)	33–40											
von Hagen (1991)	30–47	9–10										
Goodhart and Smith (1993)	15	13	13–24	12–24			21	21–34				
Masson and Taylor (1993)				24								
Pisani-Ferry et al. (1993)		17				33–42				37		
Atkeson and Bayoumi (1993)		7										
Gros and Jones (1993)		4–14										
Bayoumi and Masson (1995)	7–22	7–30	39	14–17								
Asdrubali et al. (1996)		13										
Sørensen and Yosha (1997)		15										
Athanasoulis and van Wincorp (1998)	20	10										
Obsfeld and Peri (1998)	19	10	53	13							8	3
Mélitz and Zumer (1998)	16	12–20	18	14			29	21	38	40		
Fatás (1998)		11				10		13		6		12
von Hagen et al. (1999)					0	0.03						
Decressin (1999)											30–35	20–30
Mélitz and Zumer (2002)	16	10–20	16	10–20			26	21–25	38	16–19		

* as a percentage of the negative effects of a shock neutralized by the federal/central budget in a given country
R – redistributive function, S – stabilizing function
Sources: Pacheco 2000, Kletzer, von Hagen 2000, Mélitz and Zumer 2002.

Table 2

The EU fiscal rules against the criteria of optimal fiscal rules

Criteria of optimal fiscal rules (1998)[a]	Assessment 2003[b] Original EU fiscal rules (before the 2005 SGP reform)	Assessment 2005[c] Impact of the 2005 SGP reform on fulfillment of the criteria
Well-defined: no ambiguous definitions, competence divisions or escape clauses	++	(–)
Transparent: data reporting and data analysis according to the same rules/procedures; no interpretation problems	++	(–)
Simple: rules easily understandable and observable	+++	(–)
Flexible: allow for capturing of the impact of important influences not captured in the framework, making its application less mechanistic	++	(+)
Adequate to final goal: rules should be not too broad or too narrow; legal instruments should be capable of obtaining the goal	++	(+)
Enforceable/credible: rules should be credible; application impartial; susceptible to subjective pressures	+	(+)[d]
Consistent: internally and with other policy objectives	++	(+)
Supportive of structural reforms: rules should take into account the importance of structural reforms for the economy	+	(+)

[a] Criteria elaborated by Kopits and Symanski (1998);
[b] Assessment made by Buti, Eijffinger, and Franco (2003): +++ very good, ++ good, + fair;
[c] Assessment made by the Commission (2005c): (+) improvement, (–) deterioration;
[d] Assessment of the rules compared to the situation after November 2003.
Sources: Kopits and Symanski 1998; Buti, Eijffinger, and Franco 2003; Commission 2005c.

Table 3

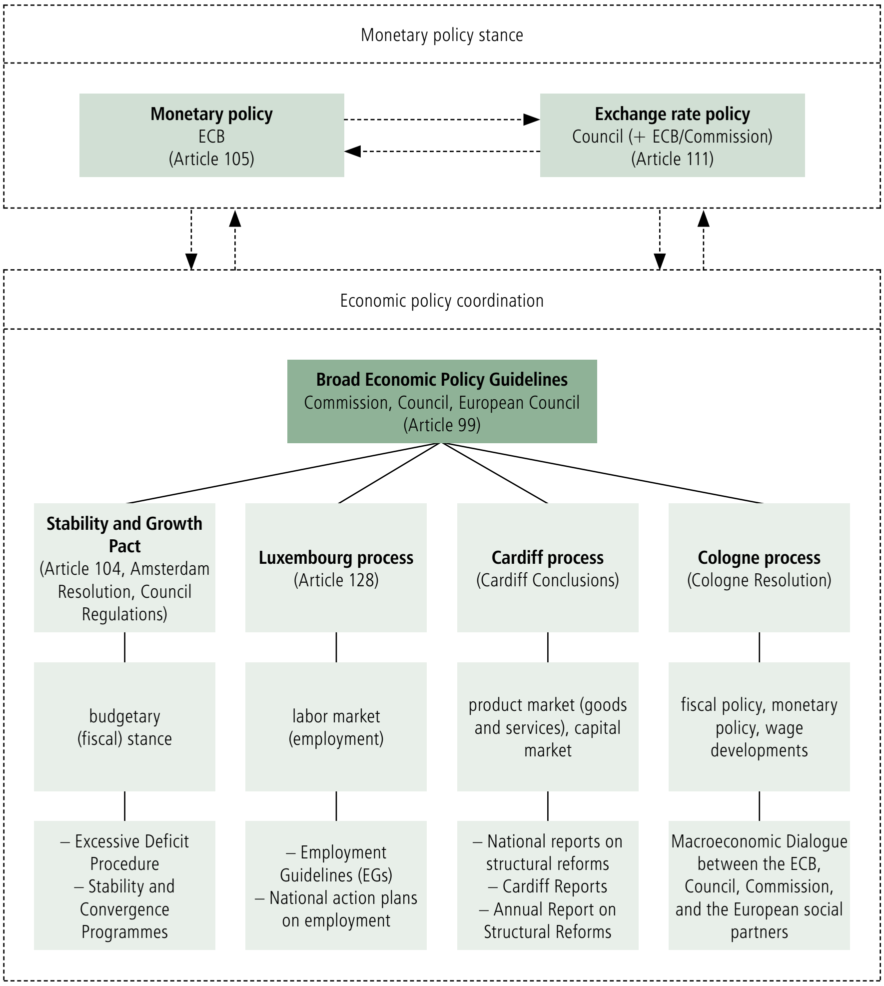
Assessment of the reformed EU fiscal framework (after the 2005 reform of the SGP)

2005 SGP reform	Overcoming excessive uniformity	Improving transparency	Correcting pro-cyclicality	Strengthening enforcement
I. Governance				
Stability program for the legislature		(+)		
Involvement of national parliaments				(+)
Reliable forecasts		(+)		(+)
Better statistical governance		+		+
II. Preventive arm				
Medium-term objectives	++	–		
Adjustment path	+		+	
Structural reforms	+	–		–
III. Corrective arm				
Exceptional circumstances	+		+	
"All other relevant factors"	+	––		––
Systemic pension reforms	+			–
Debt and sustainability	+	–	+	
Repeatability of steps	+	–	+	–
Overall assessment	**+**	**–/+**	**+**	**–/+**

Legend: + improvement, ++ strong improvement, – deterioration, –– strong deterioration, (+) improvement if effectively implemented at the national level
Source: Buti 2006.

Figure 1

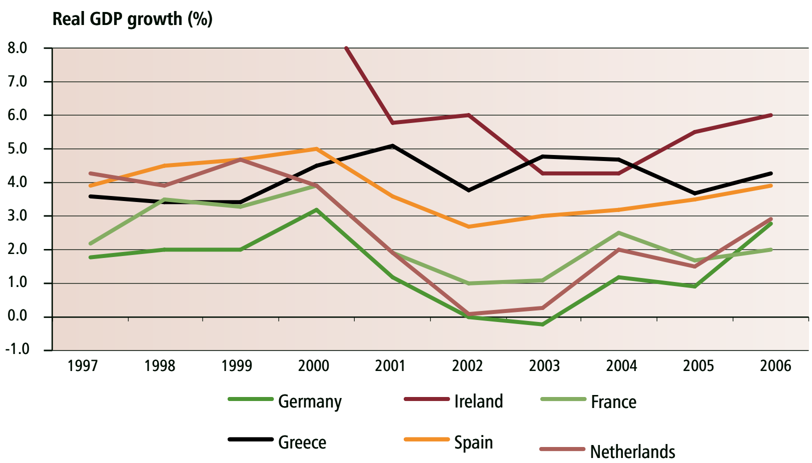
Original framework for economic policy coordination in the EU and in the euro area (including the dialogue with the ECB)

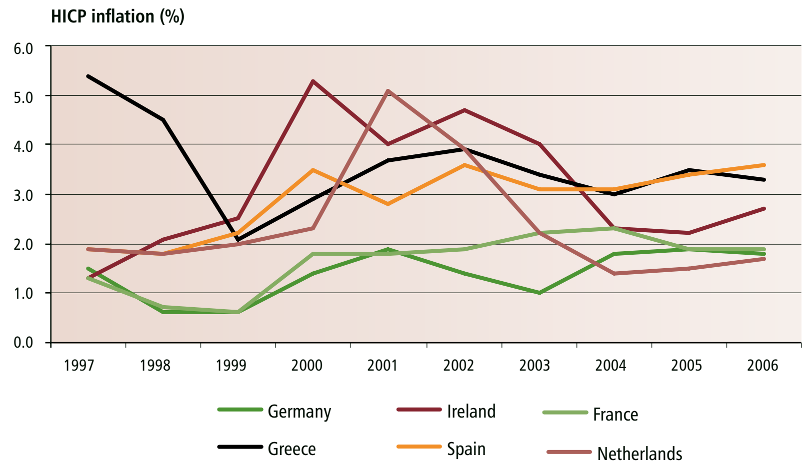


Source: author's elaboration based on Commission 2002b.

Figure 2/Table 4

Real GDP growth and inflation rates* in selected countries of the euro area (1997–2006)

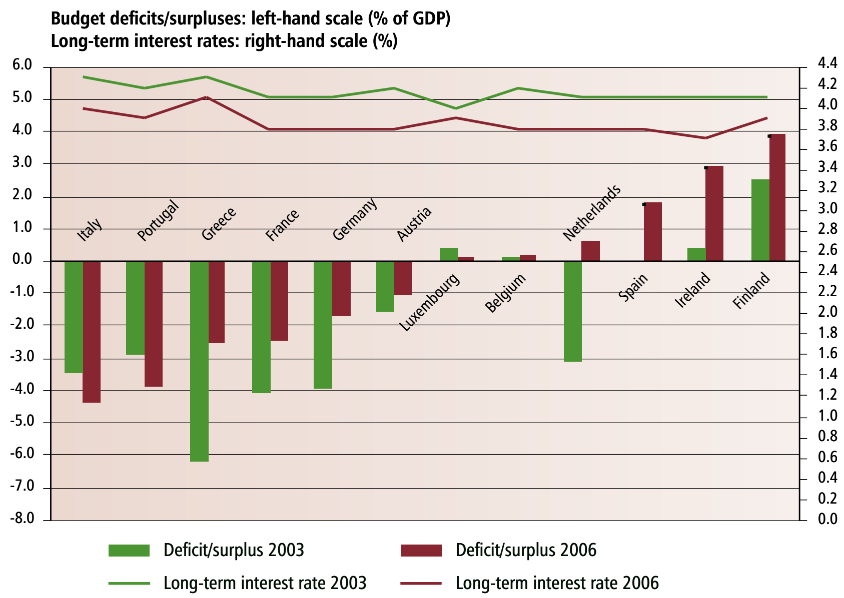




Average growth and inflation rates (1997–2006)**		Growth		
		Low	Medium	High
Inflation	Low	Germany	France, Austria	Finland
	Medium	Italy	Belgium, Netherlands	Luxembourg
	High		Portugal	Ireland, Greece, Spain

* Inflation rate measured by the Harmonized Index of Consumer Prices (HICP)
** Compared to the average rates of the euro area
Source: author's elaboration based on Commission 2007a.

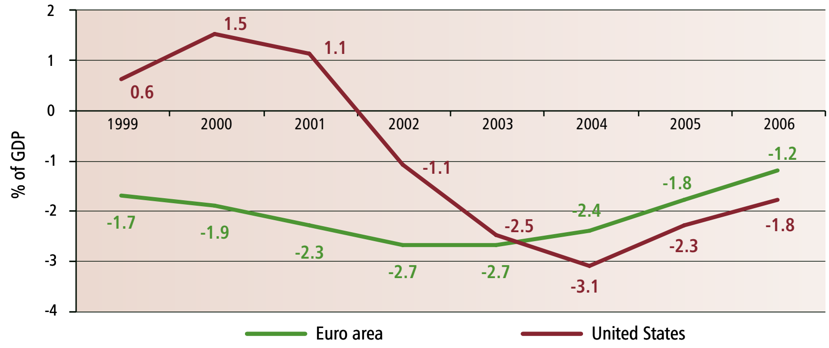
Figure 3
General government deficits/surpluses and long-term interest rates* in the euro area (in 2003 and 2006)



* The nominal long-term interest rates are defined as the yield on the central government benchmark 10-year bond
Source: author's elaboration based on Commission 2007a.

Figure 4

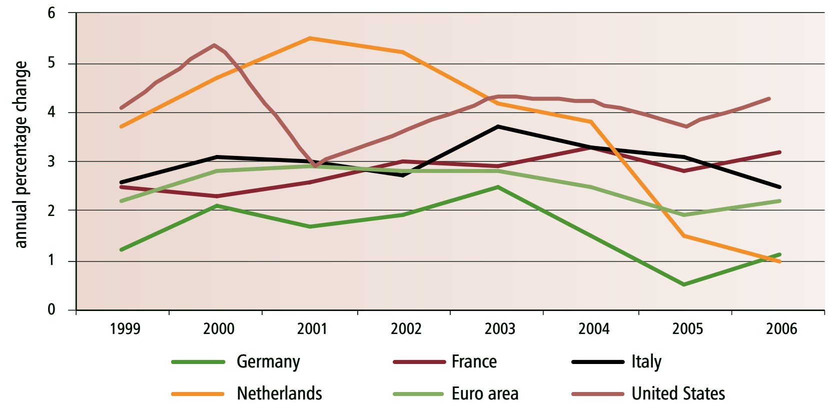
Cyclically-adjusted budget balance in the euro area and the United States (1999–2006)



Source: Commission 2003, 2007a; Congressional Budget Office 2003, 2007.

Figure 5

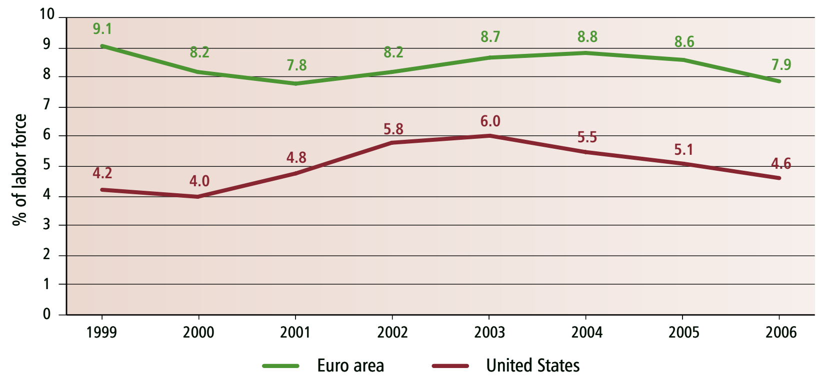
Nominal wage growth in selected countries of the euro area and the United States (1999–2006)



Source: Commission 2003, 2007a.

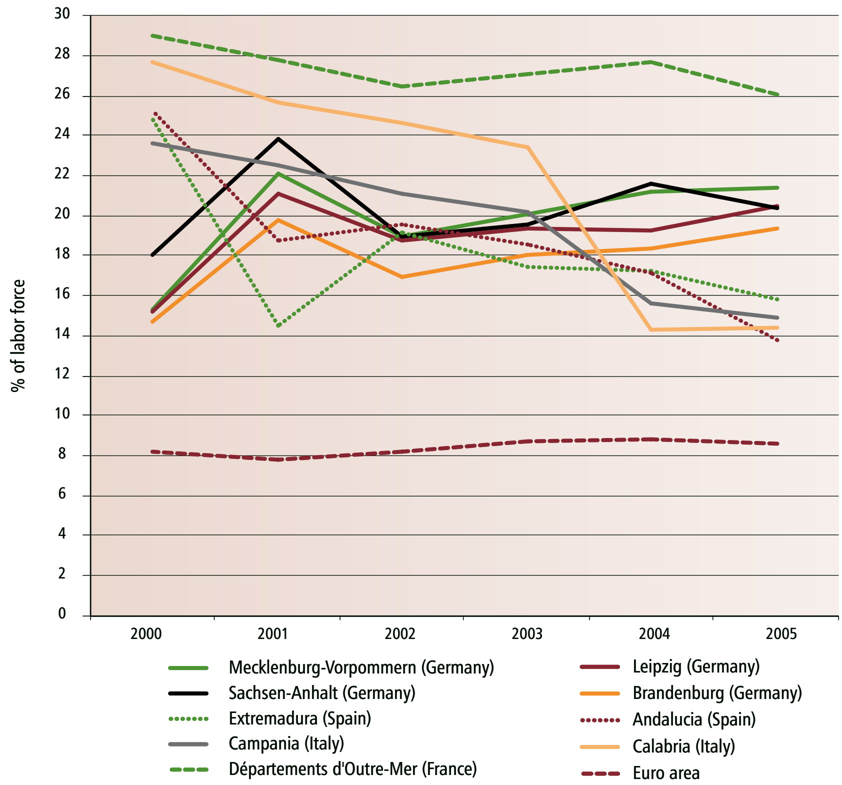
Figure 6

Unemployment rates in the euro area and the United States (1999–2006)



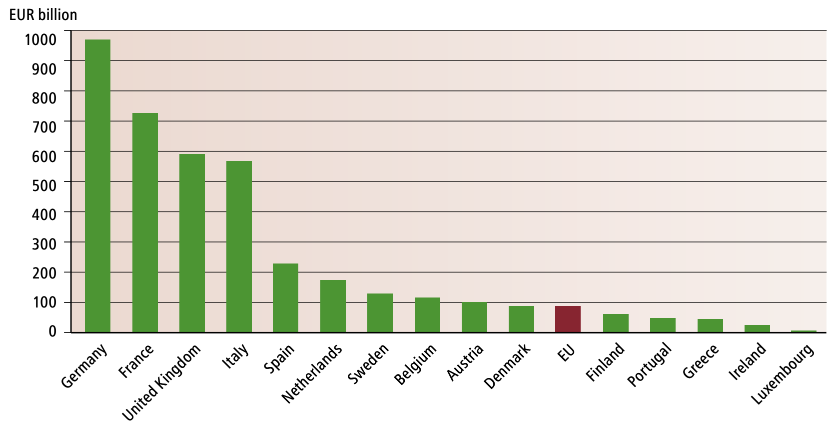
Source: Commission 2003, 2007a.

Figure 7
Regional unemployment rates in the euro area (2000–2005)



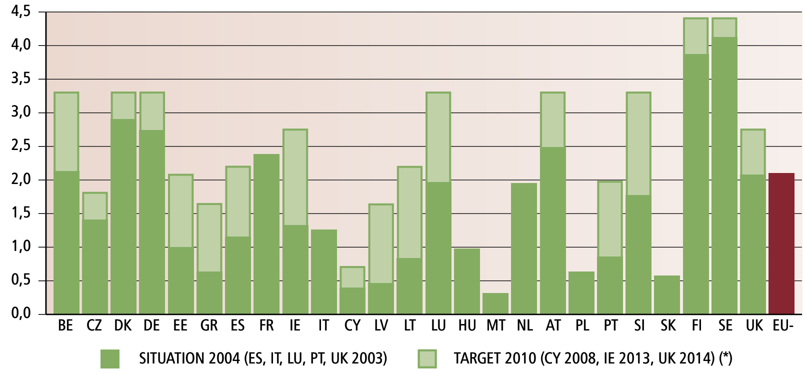
Source: author's elaboration based on Eurostat 2001-2006.

Figure 8
The EU budget vs. national budgets of the member states (expenditures in 2000) EUR billion



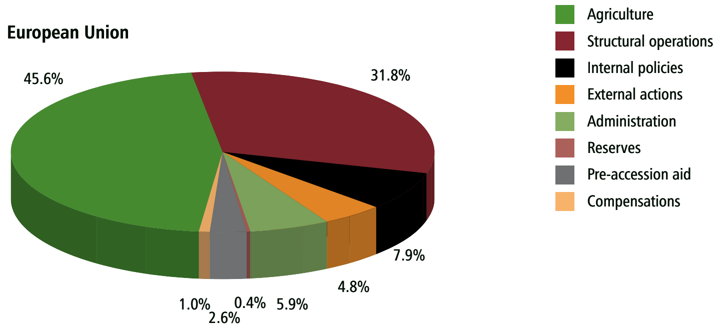
Source: European Communities 2000.

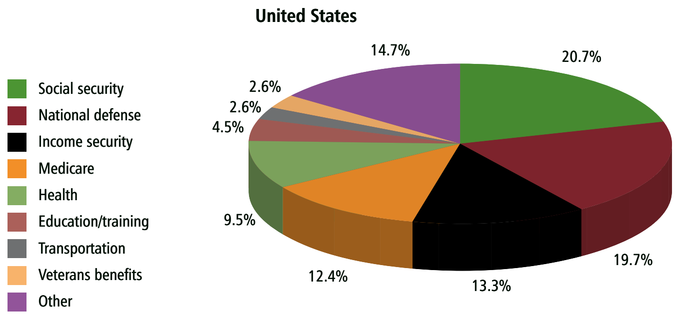
Figure 9
Gross domestic spending on R&D in the EU member states (as % of GDP)



* DK >3%; IE as % of GNP (not GDP); NL aim at a "top 5" position.
Source: Commission 2006a.

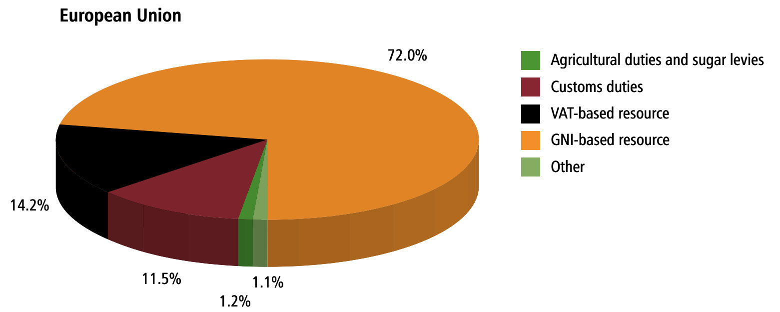
Figure 10
The structure of expenditures/outlays of the EU general budget and the U.S. federal budget (in 2006)

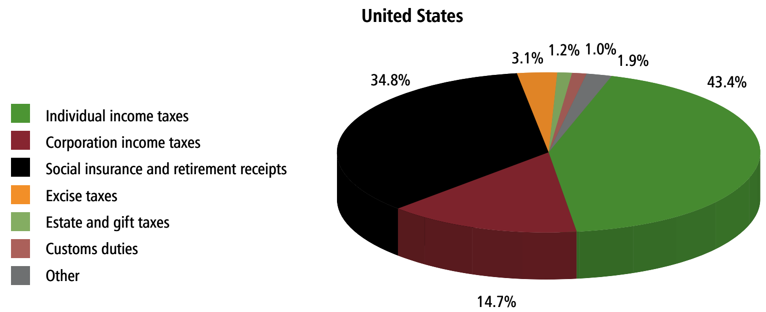




Source: author's elaboration based on Commission 2006b and Office of Management and Budget 2007.

Figure 11
The structure of revenues/receipts of the EU general budget and the U.S. federal budget (in 2006)





Source: author's elaboration based on Commission 2006b and Office of Management and Budget 2007.

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