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EURO ZONE CRISIS MANAGEMENT FROM NEOFUNCTIONALIST PERSPECTIVE AND THE POSSIBILITY OF A EUROPEAN FISCAL UNION

The global economic crisis of 2008-2009 had a serious impact on the Economic and Monetary Union. As a result of the crisis, member states decided to launch significant reforms with the primary aim of strengthening the European Economic Governance. The aim of the paper is to provide a general overview on the current debates about a European Fiscal Union. Furthermore, the study raises the issue of a larger budget, which would probably be the most powerful element of a fiscal union. The paper argues that neofunctionalism has a relevance in explaining the Eurozone-crisis management in the long term.

2008-2009-es gazdasági világválság súlyos hatással volt az Európai Gazdasági és Monetáris Unióra. A válság eredményeként a tagállamok reformokat kezdeményeztek azzal a céllal, hogy megerősítsék az EU gazdasági kormányzását. A tanulmány célja egy áttekintő kép nyújtása az európai fiskális unióról szóló vitákról. Továbbá, a tanulmány felveti a nagyobb költségvetés lehetőségét, ami a fiskális unió legerősebb eleme lehet. Írásomban emellett érvelek, hogy a neofunkcionalizmus hosszútávon megmagyarázhatja az eurózóna válságkezelését.

1. INTRODUCTION

The global economic and financial crisis of 2008-2009 and its negative consequences had a serious impact on the European integration, especially on the Economic and Monetary Union (EMU). The prolonged duration of the crisis put significant pressure on the national budgets and narrowed the room for maneuver for economic policy [Kutasi, 2017]. The depression led to sovereign debt crises in numerous member states of the Euro Area which revealed the latent problems (sub-optimality) of the EMU. In this respect, the asymmetric architecture of the Eurozone can be mentioned primarily. It refers to the dichotomy that monetary policy became a truly supranational territory, while fiscal policy remained in the hands of the Euro Area members. The crisis affected the Eurozone so deeply that its break-up was among the potential scenarios [see e.g. Aslett and Caporaso, 2016; Benczes, 2013]. Consequently, the member countries finally decided to launch significant reforms in order to strengthen European Economic Governance (EEG)². Niemann and Ioannou [2015] argue that *'the pre-crisis institutional framework considerably advanced under all main policy areas of EMU'* [Niemann and Ioannou, 2015: 7].

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² It is important to distinguish between the concepts of 'European government' and 'European governance'.

This reform process is a very significant and relevant issue from the perspective of the integration theory as well since it may cause the transformation of the EMU's (and also the EU's) structure and functioning. The theoretical debate between the two major integration theories –neofunctionalism and (liberal) intergovernmentalism – can be perceived regarding the Eurocrisis-management, too. Neofunctionalist school focuses on the puzzle of supranational reforms, while intergovernmentalism concentrates on divergent national preferences [Hooghe and Marks, 2019]. The key question here is whether the new solutions will result in the deepening of the EMU (and indirectly of the EU). Considering the fact that functional pressures were amplified due to the sovereign debt crisis, it seems logical to argue in favor of the relevance of the neofunctionalist theory. Focusing on the asymmetry of the EMU, the creation of a European Fiscal Union (EFU) could mean the springboard towards the fiscal federalism. The aim of this paper is to provide a general overview on the current theoretical debates regarding the EFU. The study approaches the issue in neofunctionalist context, and argues that this theory may have relevance in the Eurozone-crisis management. The next section gives a short summary on the ontology and evolution of neofunctionalism in order to establish the theoretical framework of the paper. The third part presents the potential elements and definitions of a fiscal union. Furthermore, the section introduces the current views about the creation of a European Fiscal Union as well. The fourth part focuses on the strengthening of the fiscal capacity of the EU/EMU and argues in favor of a larger common budget. Finally, the paper summarizes the existing contributions to the topic, and draws some conclusions from theoretical perspective.

2. THE ONTOLOGY AND EVOLUTION OF NEOFUNCTIONALISM

Following the establishment of the European Coal and Steel Community (ESCS) in 1951/1952, and the European Economic Community (EEC) in 1957/1958, scholars (economists and political scientists) have started to study the new political entities from theoretical perspective. As a result, a new research field – namely the (European) integration theory – emerged within the territory of international relations theory.

Based on the works of Ernst Haas and Leon Lindberg, neofunctionalism became the first real integration theory which tried to amalgamate the logic of functionalism and federalist goals [Tranholm-Mikkelsen, 1991]. However, it has to be emphasized that the founders of neofunctionalism gave somewhat different definitions to the process of integration. According to Haas [1958], integration means *'the process whereby political actors in several distinct national settings are persuaded to shift their loyalties, expectations and political activities toward a new centre, whose institutions possess or demand jurisdiction over the pre-existing national states. The end result of a process of political integration is a new political community, superimposed over the pre-existing ones'* [Haas, 1958: 16]. It can be seen that the definition of Haas contains a dependent variable – i.e. a new political community – as an end point of the process. Lindberg [1963]

Based on Heise [2008] European government can be defined as *'the establishment a potent, supranational actor who is able to control financial resources and establish rules, i.e., some form of supranational, European government'*, while European governance is the *'establishment of a system of multilateral negotiating or networking in order to coordinate national policies that are prone to externalities and free-riding behaviour, i.e. governance without a supranational government (but obviously not without national government)'* [Heise, 2008: 4].

provides another approach without referring to the shift in loyalties and to a final outcome. In his view, integration is '(1) the process whereby nations forgo the desire and ability to conduct foreign and key domestic policies independently of each other, seeking instead to make joint decisions or to delegate the decision-making process to new central organs; and (2) the process whereby political actors in several distinct settings are persuaded to shift their expectations and political activities to a new center' [Lindberg, 1963: 6]. In spite of this difference, Haas and Lindberg established a comprehensive theory, the aim of which was to describe, explain, predict and prescribe the process of the 'European project' [Tranholm-Mikkelsen, 1991].

The original theory consists of five basic assumptions which summarize and explain the driving force of the integration. Firstly, neofunctionalists see the integration as *a process* that evolves over time and has its own dynamic. Secondly, integration is characterized by *multiple, diverse and changing actors*, who may also create transnational coalitions. Thirdly, the theory assumes that actors who make decisions are *rational players* which practically means that they have the ability to learn from their experiences. Regarding decision-making process, neofunctionalism assumes that integration evolves through *incremental decision-making* (marginal adjustments) instead of grand designs. Finally, the cooperation of actors is often better characterized by *positive-sum games*, in other words, by a win-win situation [Niemann and Ioannou, 2015]. The key concept of the theory is the '*spillover*' which gives momentum to the integration from time to time. In short, spillover refers to the process whereby member states of an integration try to resolve their dissatisfaction either by expanding the scope of mutual commitment or by increasing the level of it or both [Schmitter, 1969]. In the beginning of the European integration, the expansion of the cooperation – i.e. the establishment of the EEC and the Euratom – was the evidence of the existence of spillover. In summary, due to the the initial success of the ECSC and the EEC, neofunctionalism became the dominant theory in the early periods of integration theorizing [Leuffen et al., 2013].

As a result of the stagnation of the integration process from the mid-sixties, the theory seemed to have lost its explanatory power by the end of the decade. The rise of protectionism (economic nationalism) caused by the oil crises, and the economic recessions in the seventies, hampered the cooperation among the member states of the European Community. Following the so called 'empty chair' policy in France, a new theory appeared in the scholarly literature which was actually based on the conventional realist theory of international relations. This new, state-centric conception of *intergovernmentalism* became and remained the dominant integration theory until the adoption of the Single European Act (SEA) in 1986.

The new Treaty – i.e. the SEA – laid down the plan for establishing the single market by the end of 1992. In relation to this, it soon became obvious that a well-functioning internal market needs tighter economic and monetary cooperation as well. As a result, the member states decided (again) on the creation of the Economic and Monetary Union. These events gave a significant momentum to the integration and to neofunctionalism, respectively.

After the introduction of the single currency, and especially following the rejection of the ratification of the Constitutional Treaty, the optimistic attitude has changed significantly. Increasing economic and political problems were finally further exacerbated when the sovereign debt crisis hit. Currently, one can ask the question whether the reforms of the EMU, and the strengthening of the European Economic Governance may lead to a wider and/or a tighter cooperation within the Eurozone (and also in the EU). Put differently, is neofunctionalism a relevant school in explaining and predicting the integration process? The next section focuses on the potential elements and the current debates of the European Fiscal Union which would be one of the most important elements of the crisis management.

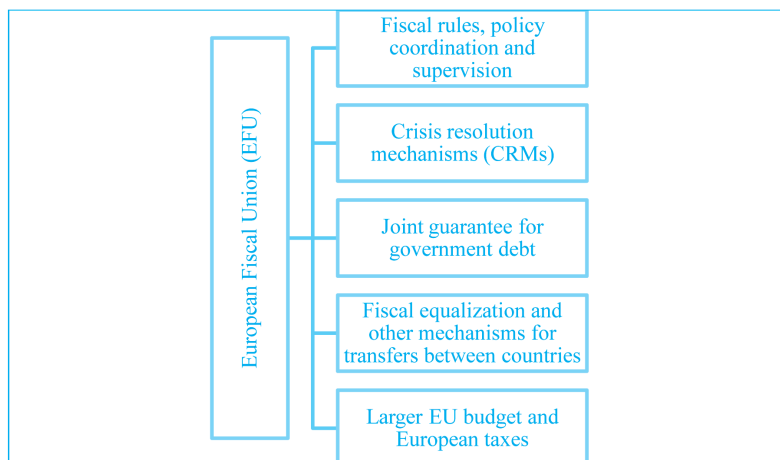
3. EUROPEAN FISCAL UNION: A FUNCTIONAL SPILLOVER?

Given the dichotomy between the supranational monetary policy and national budgetary policies, it seemed logical after the sovereign debt crisis to focus on the fiscal side of the EMU. Nevertheless, member states are seemingly reluctant to delegate further fiscal competences to supranational level because of divergent preferences. In spite of this, based on the negative experiences of the latest crisis, the establishment of a fiscal union within the EU should be seen as a functional spillover.

The idea of a European Fiscal Union was first published in the report of the European Council in 2012 [Rompuy, 2012]. The objectives of this report were later confirmed in the 'Report of the Five Presidents' published by the European Commission [Juncker et al., 2015]. The EFU would strengthen the 'economic' side of the EMU, which would lead to a closer integration structure. This institutional design is typical in federal countries (such as the United States of America or Germany) where the issue of centralization/ decentralization of different fiscal competences is a key point.

However, it is problematic that a single definition of fiscal union cannot be found in the scholarly literature. For instance, Dabrowski [2015] defines fiscal union in broad terms, '*as transfer of part of fiscal resources and competences in the area of fiscal policy and fiscal management from the national to supranational level*' [Dabrowski, 2015: 7]. Bordo et al. [2011] stresses that a fiscal union entails fiscal federalism among its member states [Bordo et al., 2011]. Thirion [2017] emphasizes that the term fiscal union have different meanings from a set of fiscal rules to a fully-fledged federal government with tax and spending authority. The author identifies the following building blocks of a fiscal union: (1) rules and coordination; (2) crisis management mechanisms; (3) banking union; (4) fiscal insurance; and (5) joint debt issuance. Fuest and Peich [2012] also identify five criteria for a fiscal union: (1) fiscal rules, policy coordination and supervision; (2) a crisis resolution mechanism; (3) joint guarantee for government debt; (4) fiscal equalization and other mechanisms for transfers between countries; and (5) a larger EU budget and European taxes. However, the authors stress that a fiscal union does not have to contain all the elements [Fuest and Peichl, 2012].

Figure 1: Potential elements of a European Fiscal Union



Source: own figure based on Fuest and Peichl [2012]

The first element consists of a set of rules such as the Stability and Growth Pact (SGP), supplemented with the Excessive Deficit Procedure (EDP) and sanctions. In response to the crisis, new rules (e.g. the ‘Sixpack’, the ‘Twopack’ or the Fiscal Compact) have been introduced in order to strengthen the budgetary discipline and supervision [Fuest and Peichl, 2012]. Benczes [2018] stresses that the EU has always been in favor of fiscal rules. Following the entry into force of the Maastricht Treaty, several national and supranational fiscal have been adopted within the Union [Benczes, 2018]. Crisis resolution mechanisms play a key role in dealing with insolvencies of member states. Unfortunately, prior to the crisis, such mechanisms did not exist in the Eurozone. Presently, the European Stability Mechanism (ESM) can provide financial assistance for insolvent countries, although it is questionable whether its capacity is sufficient in case of a deep crisis. Joint guarantee for government debt could be the third building block of a fiscal union and may exist in several forms (e.g. the Eurobond or a debt redemption fund). In spite of the fact that there were heated debates on the possible introduction of Eurobonds, no progress has been made in this area until now. The fourth possible element is a kind of fiscal equalization system and other mechanisms for permanent transfers between member states. It is very important to underline that the current EU budget does not include permanent transfers related to the EMU. Member states can get transfers only in the framework of the Regional (Cohesion) Policy and the Common Agricultural Policy (CAP). Permanent redistribution transfers would require a larger EU budget, which should be the fifth element of the fiscal union. The last part focuses on the strengthening of the European fiscal capacity [Fuest and Peichl, 2012].

4. STRENGTHENING THE FISCAL CAPACITY: THE NEED FOR A LARGER BUDGET

Federal countries typically have sizeable budgets, therefore it is possible to centralize important functions [Wolff, 2012]. However, it is quite problematic that fiscal sovereignty is one of the most sensitive areas, which may hamper the progress in this field [Szezlér, 2017]. Compared to existing federations – especially to those, which are also currency unions – the EU’s fiscal capacity is extremely undersized, and represents only 1 percent of the EU GDP [Kakol, 2017; Cottarelli, 2016]. The revenue side consists of customs duties (traditional own sources), of a small percentage of VAT revenues and, predominantly, of national contributions. Furthermore, own revenues are not allowed to exceed 1.23 percent of the EU’s GNI. In parallel, the spending side contains only some programs related to the regional (cohesion) policy and the common agricultural policy (CAP) [Cottarelli, 2016; Dabrowski, 2016]. It is also an important characteristic of the budget that the EU is allowed neither to borrow, nor to accumulate budget surpluses [Dabrowski, 2016].

The MacDougall Report in 1977 already argued in favor of a large common budget. The report determined the optimal size of the budget somewhere between 5 and 25 percent of the Community’s GNP [Szezlér, 2017].

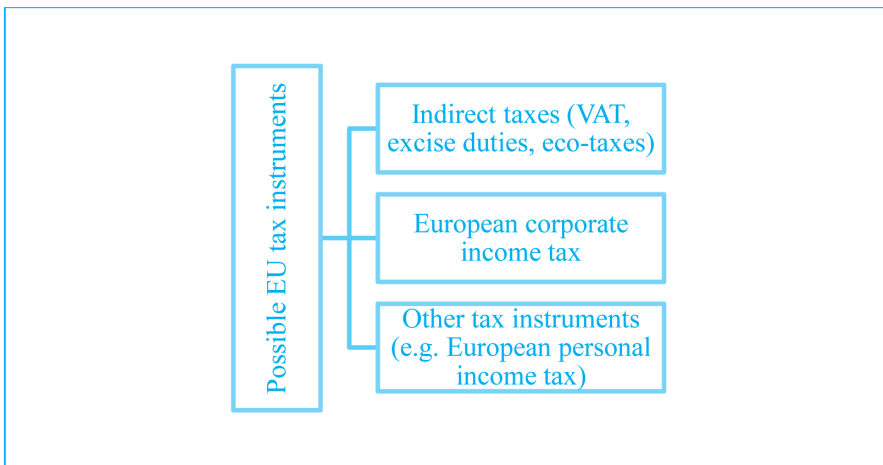
Cottarelli [2016] argues that a larger budget would be necessary to ensure the good functioning of the monetary union. This is because sizeable central budget may promote macroeconomic convergence within the Euro Area through different channels: (1) centralization of certain spending and revenue policies fosters the convergence of product and factor markets; (2) centralization of fiscal policy decisions may help to reduce the risk of free riding; (3) centralization of automatic stabilizers may be the best way to achieve risk sharing; and (4) a larger budget can more easily implement discretionary counter-cyclical policies [Cottarelli, 2016].

It is a big question, however, whether the EU budget should be increased or Eurozone should set up an own budget. Of course, both solutions have their advantages and disadvantages. Currently, a separate Eurozone budget seems more feasible, but it would also promote the model of the multi-speed EU.

The so called Meseberg Declaration [2018] adopted by Germany and France proposes the establishment of a Eurozone budget: *'We propose establishing a Eurozone budget within the framework of the European Union to promote competitiveness, convergence and stabilization in the euro area, starting in 2021. Decisions on the funding should take into account the negotiations on the next Multiannual financial framework. Resources would come from both national contributions, allocation of tax revenues and European resources. The Eurozone budget would be defined on a pluriannual basis. The purpose of the Eurozone budget is competitiveness and convergence, which would be delivered through investment in innovation and human capital. It could finance new investments and come in substitution of national spending. We will examine the issue of a European Unemployment Stabilization Fund, for the case of severe economic crises, without transfers. France and Germany will set up a working group with a view to making concrete proposals by the European Council of December 2018. Strategic decisions on the Eurozone budget will be taken by the Euro zone countries. Decisions on expenditures should be executed by the European Commission'* [Meseberg Declaration, 2018: 6-7].

The idea of a larger fiscal capacity obviously raises the issue of the resources. It brings us to the topic of European tax(es), because the existence of such common revenues are almost indispensable to create a genuine economic (fiscal) federation. Several proposals can be found in the literature related to the issue of European taxes. Marján [2013] claims that a potential European tax should be introduced in a 'budget-neutral' way. Probably, the sharing of VAT revenues between the EU and the member states would be the best way of this [Marján, 2013]. Le Cacheux [2007] identifies several potential forms of European taxes.

Figure 2: Possible EU tax instruments



Source: own figure based on Le Cacheux [2007]

He argues that indirect taxes should be potential revenues at the EU level. A European VAT may be regarded as a neutral form of taxation (if it does not tax savings). Furthermore, the transfer of a

part of VAT revenues to the common budget would technically relatively easy. On the other hand, it has to be highlighted that VAT is often considered to be unfair since it taxes low-income individuals, who spend relatively more on consumption. Alternatively, excise duties levied on alcohol, tobacco and fuels could be possible instruments as well. The same principles apply to eco-taxation – i.e. to Pigovian taxes – which may also provide revenues by taxing environment-damaging activities. The second type of European tax instruments could be a European corporate income tax. The advantage of such a tax item would be relatively small costs of the administration, given the fairly small number of taxpayers. However, relatively large fluctuations in the annual yield of the corporate income tax caused by business cycles may be the main disadvantage of the item. Finally, other taxes (e.g. a European personal income tax) may also play a role in a larger common budget [Le Cacheux, 2007]. In summary, potential solutions are available, the implementation depends primarily on the attitude of the member states.

5. CONCLUSION

Following the outbreak of the sovereign debt crisis, numerous reforms have been launched in the Eurozone. The aim of this paper was to present the current views regarding the debates on a possible European Fiscal Union, and a larger fiscal capacity (EU budget). The study used a neofunctionalist approach in order to argue that the concept of the EFU should be seen as a functional spillover, which may be a significant springboard towards fiscal federalism in the long run. A larger common budget supplemented with common tax revenues (European taxes) would probably be the most powerful building block of a fiscal union. The exact form and content of this system is still vague, but it has to be underlined that the creation of a genuine fiscal union would be an important milestone in the deepening process of the integration.

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