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Abstract

In this paper, we compare the present process of definition and implementation of fiscal policies in the European Union with the main conclusions of the "fiscal federalism" theory. This is done in order to draw possible lessons for future evolution, particularly taking into account the possibility of creating a European "Federation of Nation-States", which we supported in a previous work.

We argue that these main conclusions are easily compatible with the emergence of a largely decentralised "Federation", but are still far distant from the present situation. In this context, we argue for several important lines of change in the short-run, namely an effective change in the process of coordinating fiscal policies and a credible reform of the Stability and Growth Pact, and in the medium-long-run, namely an important increase in the size of the European budget.

Keywords: Fiscal federalism, fiscal policy, European budget, fiscal discipline.
JEL Classification: E62; H77; H61.

1. Introduction

Almost 60 years have gone by since Robert Schuman's famous speech (Schuman, 1963), in which he described the "European federation" as the ultimate goal of the integration process that was beginning at that time. However, the results of this process are clearly different for the two perspectives that comprise it: economics and politics.

In economic terms, advances have been made at a good pace, and the European Union (EU) is now in the most advanced state of economic integration possible, with the single currency, free movement of goods, services, capital and people and several common policies. However, these advances have not been matched in the political field, where the Union has, in fact, failed to establish a strong entity and to develop common actions with a similar impact.

This divergence is a fundamental trait of the present EU situation, which might be characterised as a crossroads: along with the above mentioned advances, there are four aspects in which the results fall well short of what would be desirable, or four fundamental deficits: "competitiveness and economic growth", even if the situation seems to be changing in last few months: "political weight", with the EU often behaving as a "dwarf" on the international political scene; "legitimacy and participation", in view of the poor scrutiny of some European institutions, ambiguity in the sharing of competences between Member States and the EU and indifference of citizens facing the process of integration; and "capacity for decision and action", faced with unsuccessful institutional reforms and the permanence of a poor-sized community budget.

These "deficits", particularly the last three, show that the goal of creating an expanded space of European solidarity, which would give rise to a political entity and a true European citizenship, remains well out of the EU's reach. 50 years after the Treaty of Rome, the weight of national interests is often still predominant, which means that these "deficits" will be difficult to overcome unless there is a significant change in the Union's politico-institutional organisation model. That is to say, unless there is a rebalance in the two sides of the integration process, with a deepening of the political field.

In previous studies, (*e.g.* Alves, 2007) we defended that this rebalance would involve the EU becoming an organisation capable of dealing efficiently with the need for unity in clearly supranational fields, without endangering European diversity, and that the most suitable model for doing so would be that of a "Federation of Member States", with highly decentralised competences.

Such evolution would have to be accompanied, at the level of economic organisation, by a growing approximation to the "rules" of the theory of fiscal federalism. This is the context in which we present this paper, whose main topic is the comparison between the present process of defining and implementing fiscal policies in Europe and the one that should result from the application of these "rules", thus with a focus on the function of macroeconomic stabilisation.

If we add to this comparison some elements related to the functions of supply of public goods and services and redistribution and to the exercise of democratic legitimacy, it becomes possible to analyse the gap between the method of economic organisation in the European Union and that which should correspond to a "Federation of Nation States".

That is the overall aim of this paper. It begins with a brief look at the literature on fiscal federalism, establishing its fundamental traits and possible implications for the European case (section 2). The paper continues by presenting the essential elements of the European Union's economic organisation, with particular emphasis on the discussions concerning fiscal discipline and the size of the community budget (section 3). The path is then open to analyse the essential question: "how far is this economic organisation from that resulting from the theory of fiscal federalism (section 4). It concludes with some final remarks and implications for the future (section 5).

2. The theory of fiscal federalism: what major lessons for the EU?

As Oates (1999) points out, the use of the term "federalism" in Economics is somewhat different to its normal use in Political Science. In the latter, it refers to a political system with a Constitution that guarantees a set of principles and proceeds to the sharing of competences between the various levels of power. In the case of Economics, all public sectors are relatively "federalised", given that all of them provide public goods and services and have some autonomy of decision: it deals, then, essentially with the questions that involve the vertical structuring of the public sector.

In this context, the fundamental aim is to find the most suitable way of sharing responsibilities and of using instruments through the various levels of "government", so as to optimise their performance.

As there are clearly no rules or rigid formulas that determine a situation of "fiscal optimum", which is highlighted by the diversity of fiscal structures in the various federations (similarly, in fact, to the case of political and institutional structures), the literature in the framework of the so-called "fiscal federalism" has attempted to find some guidelines for the vertical structuring of government.

The essential purpose of this literature is, therefore, the suitable sharing of competences among the various levels of government (and not, as it may sometimes seem, fiscal decentralisation for itself alone), or, as Oates (1998) says, identifying the institutional design that will best allow the public sector to respond to the variety of the demand aimed at it.

Traditionally, the theory of fiscal federalism is concerned with three essential aspects: the sharing of functions between the different levels of government - particularly at four levels (Spahn, 1994): supply of public goods and services; redistribution of income; macroeconomic stabilisation; and taxation - the identification of welfare gains resulting from fiscal decentralisation; and the use of the instruments of fiscal policy (particularly issues associated with taxation and inter-governmental transfers).

Through time, the field of fiscal federalism has been broadened as other topics emerged, including, among others, questions related to inter-jurisdictional competition and "environmental federalism" (*e.g.* Enrich, 1996; Oates and Schwabb, 1996), "market preserving federalism" (*e.g.* Weingast, 1995; McKinnon, 1997) or decentralisation in developing economies or those in transition (*e.g.* Bahl and Linn, 1992; Shah, 1994).

Briefly analysing these fundamental topics of the theory of "fiscal federalism", it is possible to find some elements that should be determinant in structuring the competences of the various levels of power within the EU context, particularly taking into account a possible evolution towards a federalist model.

The main conclusions of the theory of "fiscal federalism" seem largely compatible with the idea of the evolution of the EU towards a broadly decentralised federal model (the "Federation of Nation-States") and for the need to, in this context, create a "European economic government" that would be responsible for competences assigned, in this field, to the central level of power.

Similarly, they seem to sustain the idea that is possible to obtain significant welfare gains through the creation of such a strongly decentralised federal fiscal system, provided that it is suitably designed and taking into account aims of equity and efficiency. In this design of the Federation's vertical structure at the fiscal and budgetary level, the aspects below would be decisive for the success of the model, taking into account the main elements of the available literature.

In the first place, the need for a clear and transparent application of the principle of subsidiarity, in terms of the question of the supply of public goods and services, with centralisation occurring for a small number of policies, those that have clear supranational nature (such as defence, security and monetary policy, among other fields). This would avoid too much "central" intervention (Oates, 1972), something that may have happened in the European case within the present institutional model.

In this field, the (still) marked diversity in demands and national preferences, plus the (still) low mobility of families should not put the gains of decentralisation at risk (Spahn, 1994): they will probably even highlight them, since they will not cause exaggerated distortions (Flatters *et al.*, 1974). In fact, even if there were spill over effects, the advantage of cooperation among the different levels of government that are closest to citizens could easily outbalance the centralised solution.

Still within the context of competence sharing in the scope of the supply of public goods and services, despite the validity of the decentralisation principle, there seems to be a need, in some fields, to take particular care with certain negative consequences resulting from competition between the Federation Members, as it eventually would lead to poorer standards (Enrich, 1996). In the European case, this would be particularly noticeable in the fiscal and environmental fields, where these consequences have recently been established, and would justify greater centralisation and harmonisation.

In the second place, the need to combine some centralisation at the level of the redistribution function (Tiebout, 1956), maintaining a significant space for decentralisation, taking into account various motives: reduced geographic mobility; failure of some sub-national programs of redistribution (*e.g.* Feldstein and Wrobel, 1998, for the case of the USA); extended aims of the regional redistribution function (King, 1984); and the added concern with the most disadvantaged that are closer (Pauly, 1973), which could be an important issue in the European case since it deals with different countries (and regions), with different traditions, values and histories (or rather, once again diversity justifying some degree of decentralisation).

In this context, a summary of the main theoretical and empirical references in this field seems to suggest that, in the case of the European Union, the redistribution policy would be maintained at the national level, particularly with regard to individual redistribution, while there would also be some space for inter-regional redistribution, namely via transfers through the community budget.

Thirdly, the need to assess the real importance of the fiscal policy for the purposes of macroeconomic stabilisation (Solow, 2004). The literature in the scope of fiscal federalism traditionally postulates the importance of a significant central budget, which, through the transfer mechanisms between the States/regions positively affected by asymmetric shocks and the States/regions negatively affected by the same shocks, seems to exercise an important degree of stabilisation (Spahn, 1994). This has, in fact, been established through several studies, in the wake of the analyses of Sala-i-Martin and Sachs (1992), Italianer and Pisani-Ferry (1994), and Bayoumi and Masson (1995) and, who estimated, based on different methodologies, a significant degree of stabilisation in the absorption of shocks by the North-American federal budget.

The same type of role was mentioned by subscribers to the theory of optimal currency areas (following the seminal works of Mundell, 1961, and Kenen, 1969), who considered that, once the monetary and exchange instruments were lost, an efficient response to the negative effects of specific and asymmetric shocks, in the context of a monetary union, would only be obtained through one of three mechanisms: broad flexibility of prices and salaries; strong mobility of labour; or fiscal transfers via a wide central budget. Since these do not exist (or, at least, only in a weak situation), the solution would be to move to national fiscal policies with high flexibility.

As a result of these elements, and with regard to the EU, it becomes relevant to discuss the best way of pursuing aims of macroeconomic stabilisation, knowing the difficulties at the level of labour mobility and the flexibility of some labour markets, as well as the significant difficulties of a political nature in promoting both a broadening of centralisation and expansion of the Union budget.

In the fourth place, at the level of the instruments of fiscal federalism, it is worth highlighting the existence of a set of relevant elements: the existence of certain guidelines (namely, the criteria defined by Musgrave, 1983) for a potential design of a "European" fiscal system, despite criticisms of the traditional criteria and the obvious political difficulties (Alves, 2000); and the need to promote conditional transfers for internalising spill over effects (Oates, 1999).

There is also the need to take into account the problems, namely political ones, generated by transfers, whose aim is that of "fiscal equalisation" (*e.g.* McKinnon, 1997; Usher, 1995) and, as such, the concern with a certain *trade-off* between the goals of greater homogeneity of the levels of economic growth and economic and social cohesion and the problems deriving from the existence of taxpayers and net receivers. Finally, the need for some care in constructing the mechanism(s) of "income sharing", without the associated transfer system(s) being too broad, so as not to encourage increasing budgetary laxity.

In the fifth place, some literature, following the pioneer work by Inman and Rubinfeld (1997) and considering both economic and political goals, seems to highlight the idea favourable to a largely decentralised federal system, indicating the possibility of strengthening citizens' political participation, which could overcome the possible costs associated with a reduction in economic efficiency. This could be particularly relevant in the European case, where there is a significant challenge in the field of legitimacy and democratic participation.

Finally, some literature also indicates that, under certain conditions, federalism could constitute the best system for preserving and developing the market economy (Weingast, 1995). Taking the European case, this might point toward a situation where the creation of a Federation would positively contribute towards strengthening European competitiveness.

In particular, it points to the fact that there seems to be a need for special attention to the problem of fiscal discipline in sub-central governments (in this case, of the Member-States). In any case, it shows that it could be enough to combine the prohibition of monetary financing of the debt and bail-out behaviours on the part of the federal government with the non-existence of exaggerated intergovernmental transfers and with the efficient functioning of credit markets to generate responsible behaviour in the sub-central fiscal authorities (McKinnon, 1997). In other words, applied to the European case, it indicates that it might not be necessary to define rules like those resulting from the Maastricht Treaty and the Stability and Growth Pact (SGP, European Council, 1997).

3. Fiscal policy(ies) in the EU: the present situation

Having analysed some major lessons that the theory of fiscal federalism may contain for the EU's economic organisation, and before moving on to assess the gap between the present situation and that which would result from an application of this theory, a brief description of the present organisational context of the euro zone is relevant. This is done below, firstly by approaching the issue of the European solution for fiscal policies and, then, with a brief reference to the issue of community budget size.

In terms of fiscal policy (and, therefore, the macroeconomic stabilisation in view of specific or asymmetric shocks), the European solution was provided for in the Treaty on European Union (1992). This foresaw that fiscal policies would remain in the hands of national governments, albeit limited by compulsory rules (particularly, restricting the public deficit to no more than 3% of GDP and the public debt to under 60% of GDP), complemented by their coordination at the level of the Council. It also foresaw the prohibition of monetary financing of public deficits and instituted a clause of national responsibility for the public debt (*no bail-out*).

This solution was designed to maintain a policy instrument that could be used at national level and, at the same time, to prevent excessive public deficits from being created and maintained (through restrictive rules) and to promote some coherence among the various national fiscal policies and between these and the single monetary policy (through a coordination mechanism).

In 1997, the SGP came to reinforce this option, particularly in terms of limiting freedom of activity. Thus, its preventive mechanism assumed budgetary balance as a medium-term goal, allowing automatic stabilisers to act and opening room for manoeuvre for some discretion in handling fiscal policy, namely when a less favourable economic evolution occurs. On the other hand, its corrective mechanism established in a more concrete way the mode of operation for "excessive deficit procedure", in particular defining the sanctions to be imposed and clarifying situations of exception.

This solution has been the target of wide discussion and great criticism, at both the academic and political level, particularly prior to 1995 and after 2000, periods in which there was greater economic difficulty. The discussion has fundamentally focused round the way fiscal discipline would be implemented and controlled (*e.g.* Buiter *et al.*, 1993; Rubio and Figueras, 1998) and not on the need for this discipline.

Thus, fiscal discipline is seen largely as necessary for preserving the stability of monetary union, which would be compromised if countries promoted excessive public deficits (De Grauwe, 2005). This situation could determine significant external effects, namely via an increase in the Union's interest rate and possible pressures on the central bank in the sense of making monetary policy more flexible. On the other hand, the possible incentive to free-riding behaviour determined by the fact that everyone in a single currency context could share the costs of a bad budgetary behaviour, and the possibility of creating excessive deficits for political reasons, would constitute additional elements in favour of a solution that would promote fiscal discipline.

This consensus was not shared concerning the way in which fiscal discipline should be implemented. This has been the main topic of a great controversy, both among defenders of the present rules (e.g. Begg *et al.*, 2004; Buti *et al.*, 2003) and defenders of relatively profound reforms (*e.g.* Casella, 1999; Arestis *et al*., 2001; Creel, 2003; Pisani-Ferry, 2004; Collignon, 2004; Wyplosz, 2005).

Criticism to the original SGP reached a peak in 2002 when the President of the European Commission at the time, Romano Prodi, classified it as "stupid" (Prodi, 2002). The critical voices, which reappeared particularly by the beginning of this century, suggested greater flexibility in rules and a greater balance between nominal and real aims, namely for: the possibility, in a situation of economic crisis, of governments having to use restrictive fiscal policies, which would be counterproductive; the fact that continued situations of stagnation or poor economic growth were not considered as exceptions regarding the application of the excessive deficit procedure; and the possibility that the time period for correcting excessive deficits was clearly too short.

This discussion, and above all the economic difficulties felt by several countries at the beginning of the present century (particularly France and Germany, the "locomotives" of the euro zone), led in 2003 to a suspension in the application of the SGP (European Council, 2003) and two years later to its reform (European Council, 2005). The major features of such reform included: an extension of the deadline for correcting excessive deficits; the need for greater attention to the evolution of the structural deficit and the weight of public debt on the GDP as central elements of fiscal sustainability in the medium and long run; the consideration of continued situations of low effective product growth (below potential) as exceptions to sanctions; and the inclusion of various "pertinent" factors that could ease situations that would fit into the concept of excessive public deficit.

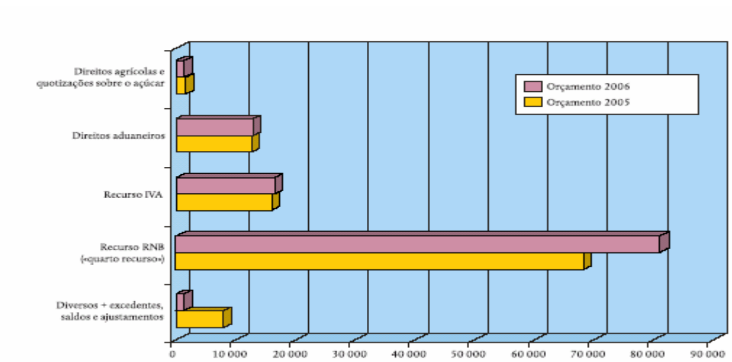
These changes have determined greater room for manoeuvre for national governments to deal with specific or asymmetric shocks, in this sense making the Pact more "flexible", considering the classification of "ideal" fiscal rules proposed by Kopits and Symansky (1998). However, by including a great diversity of "pertinent" factors in the context of the (non) excessive nature of a public deficit, the doors seem to have opened (Alves and Afonso, 2007) for a less "enforceable" Pact (or more "stupid" from the point of view of its application). In other words, new doubts have been raised as to its capacity to ensure the sustainability of public accounts in the euro zone, which are shared both by defenders of the original SGP (*e.g.* Buti *et al.*, 2005) and by its critics (*e.g.* Buiter, 2005; Allington and McCombie, 2007).

In terms of another central element, that is, the size, uses and outlooks relative to the community budget, figures 1 to 3 are particularly enlightening.

Thus, the EU budget maintains a very small weight, representing little more than 1% of the Union's GDP, in a situation that contrasts greatly with those of federations (or similar political units) with a single currency, particularly with that of the United States.

Most of the revenue comes from the so-called "GNP resource", in view of the successive drop in the importance of customs duties and agricultural duties and the stagnation followed by the drop in relevance of the "VAT resource". In other words, not only is the budget small, but also resources seem to be not truly "own", contrary to what their name suggests, leaving the EU in a very limited context of financial autonomy (Cieslukowski and Alves, 2006).

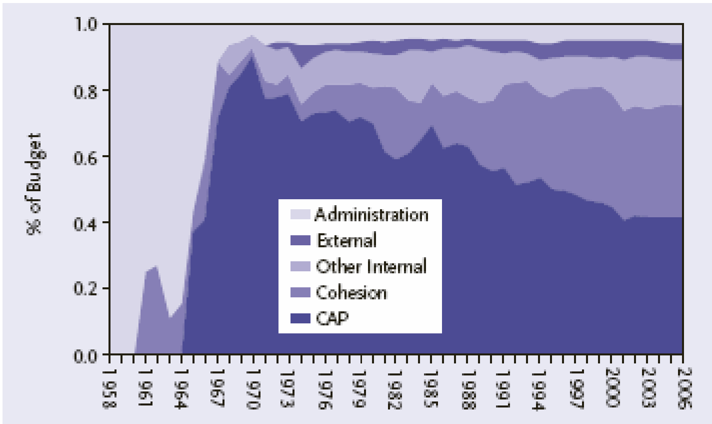
Fig. 1 – Composition of the community budget revenue (billion euros)



Source: EU site, http://europa.eu.int

Equally significant is the fact that a very substantial part of this small budget is devoted to one of the most controversial (and probably most unfair) policies in the Union: the Common Agricultural Policy (CAP). Despite its successive fall in importance in the budget (fig. 2), in favour of the policies for economic and social cohesion, the CAP continues to represent almost half of the community budget's expenses.

Fig. 2 – Composition of community budget expenses



Source: Baldwin and Wyplosz (2006)

These circumstances do not seem likely to change in the short run, as can be seen from the analysis of the financial perspectives for the period 2007-2013 (fig. 3), with a very low ceiling maintained for budget size (less than 1.3% of the Union's GNP) and significant expenses in the area of agriculture. Some reformulation of fundamental aims can be seen, particularly for competitiveness and cohesion, following the attempt for real implementation of the Lisbon Strategy, but keeping expenses with new challenges in the Union (such as foreign policy and common defence, the development of citizenship, the strengthening of the space of freedom, security and justice) at a very disappointing level.

Fig. 3 – Financial perspectives for the period 2007-2013

All figures are shown in 2004 prices, EUR Billion

Commitments Appropriations	2007	2008	2009	2010	2011	2012	2013	Total 2007-2013
1. Sustainable Growth	**51,090**	**52,148**	**53,330**	**54,001**	**54,945**	**56,384**	**57,841**	**379,739**
1a Competitiveness for Growth and Employment	8,250	8,860	9,510	10,200	10,950	11,750	12,600	72,120
1b Cohesion for Growth and Employment	42,840	43,288	43,820	43,801	43,995	44,634	45,241	307,619
2. Preservation and Management of Natural Resources	**54,972**	**54,308**	**53,652**	**53,021**	**52,386**	**51,761**	**51,145**	**371,244**
of which: market related expenditure and direct payments	43,120	42,697	42,279	41,864	41,453	41,047	40,645	293,105
3. Citizenship, freedom, security and justice	**1,120**	**1,210**	**1,310**	**1,430**	**1,570**	**1,720**	**1,910**	**10,270**
3a Freedom, Security and Justice	0,600	0,690	0,790	0,910	1,050	1,200	1,390	6,630
3b Citizenship	0,520	0,520	0,520	0,520	0,520	0,520	0,520	3,640
4. EU as a global player	**6,280**	**6,550**	**6,830**	**7,120**	**7,420**	**7,740**	**8,070**	**50,010**
5. Administration	**6,720**	**6,900**	**7,050**	**7,180**	**7,320**	**7,450**	**7,680**	**50,300**
6. Compensations	**0,419**	**0,191**	**0,190**					**0,800**
Total appropriations for commitments	**120,601**	**121,307**	**122,362**	**122,752**	**123,641**	**125,055**	**126,646**	**862,363**
as a percentage of GNI	1,10%	1,08%	1,06%	1,04%	1,03%	1,02%	1,00%	1,045%

Total appropriations for payments	**116.650**	**119.535**	**111.830**	**118.080**	**115.595**	**119.070**	**118.620**	**819.380**
as a percentage of GNI	1,06%	1,06%	0,97%	1,00%	0,96%	0,97%	0,94%	0,99%
Margin available	0,18%	0,18%	0,27%	0,24%	0,28%	0,27%	0,30%	0,25%
Own Resources Ceiling as a percentage of GNI	1,24%	1,24%	1,24%	1,24%	1,24%	1,24%	1,24%	1,24%

Source: EU site, http://europa.eu.int

4. Fiscal federalism in the EU: how far are we?

If we compare the solution adopted in the context of the Maastricht Treaty and its subsequent reforms with the main ideas highlighted in the review of the literature on fiscal federalism, there seems to be quite a large gap between the present EU framework with regard to the performance in the field of macroeconomic stabilisation (and, in general, to the definition and execution of fiscal policies) and what should occur in the context of a true Federation.

This discrepancy is even greater in three areas:

1) The community budget is small, about 1% of the Union's GDP, and no significant changes seem to be expected in it for the next few years. Added to the fact that almost half the budget is destined for the Common Agricultural Policy, this means that it cannot correspond to the functions of macroeconomic stabilisation that central budgets assume in the main federations.

2) Some of the recent developments in the theory of fiscal federalism highlight the relevance of the creation of "hard budget constraints" as a way of preserving and developing the market economy, in the framework of a highly decentralised federation; therefore, there seems to be greater synchronisation between the theory of fiscal federalism and the solution adopted for defining and executing fiscal policy in the EU, which is based particularly, as mentioned, on the development and application of compulsory restrictive rules.

Nevertheless, the said authors admitted that it could be enough to combine the prohibition of monetary financing of the debt and bail-out behaviour on the part of the federal government with the non-existence of exaggerated intergovernmental transfers and with more efficient functioning of the credit markets in order to generate responsible behaviour of the sub-central fiscal authorities.

In the European case, however, as these prohibitions exist, compulsory rules have also been adopted: nevertheless, as has also been mentioned, such rules are not consensual and do not even seem to be transparent enough or applicable in such as way as to promote the necessary fiscal discipline.

3) In the European case, not only is there a lack of credibility in the adopted rules, but also the coordination of non-monetary policies seems to be very insufficient is only just beginning, in a situation that is hardly favourable to obtaining coherence among the various national fiscal policies and between these policies and the common monetary policy. In the context of a federal economic organisation, this coherence would be largely guaranteed, even in the context of broad decentralisation of policies, since there would at least be institutions that guaranteed the definition of common fundamental aims and of general paths to follow, as well as effectively overseeing compliance with the rules.

In this context, and admitting that the fiscal and budgetary policies could still be mobilised for macroeconomic purposes and, since it seems difficult, in the short (and possibly medium) run to pursue this aim in a (traditional) framework of centralisation, with a wider community budget, the debate mentioned in the previous section and the lessons of the fiscal federalism theory could indicate the following lines of evolution, which differ according to the time horizon.

1) In the medium to long run, and in order to bring about and consolidate the politico-institutional transformation that would lead to the creation of a “Federation of Nation-States”, it would be difficult not to keep moving towards an effective reform of the community budget, which enables its expansion to levels compatible with the new demands and new challenges facing the Union and, in particular, to develop an effective mechanism for stabilisation regarding adverse shocks.

Studies recently carried out by the European Commission (2004) could, in this field, constitute a good starting point, both from the point of view of type of instruments that could shape new own resources for the community budget, and from the point of view of a summary of the main problems that are raised in order to implement them. On the one hand, these are associated with questions of fiscal harmonisation and, on the other, the necessary substitution of national fiscal burden (as well as national public expenses by Union expenses), as the only way in which the acceptance of European citizens could be considered.

In any case, it is not to be expected, nor is it politically desirable (since it would possibly imply a situation of excessive centralisation), that the community budget should be, even in the long run, similar in size to the central budgets of certain existing federations (*e.g.* that of the United States). In fact, some studies even prior to the adoption of the Maastricht programme for the single European currency, already anticipated this situation: MacDougall (1977) mentioned around 5% to 7% of the GNP; Lamfalussy (1989) referred to about 3% of the GNP. In either case, however, these values are far greater than those seen today.

2) In the short-run, and bearing in mind the political and economic difficulties derived from what was mentioned in the previous point, a more efficient resolution of the fundamental issues raised (namely, efficiency in combating the negative effects of specific and asymmetric shocks, the balance between nominal and real macroeconomic aims, the strengthening of the coherence of policy mix and the maximisation of overall well being) would seem to suggest three more immediate actions:

> a) a strengthening of the coordination of national fiscal policies, requiring a marked change in their institutional framework; as mentioned by Pisani-Ferry (2002), it would be important to adopt a code of conduct for economic policy, establish a compulsory agreement of reciprocal consultation for Members of the euro zone and of the Commission before taking the relevant macroeconomic policy decisions, to transform the Eurogroup into an executive entity with decision-making capacity through a qualified majority, to transform the (national) stability programmes into true instruments of coordination and supervision and to create constructive dialogue between the Eurogroup and the European Central

Bank, allowing useful and coherent interaction in terms of structural reforms and macroeconomic policy;

b) a credible reform of the Stability and Growth Pact, as a relevant mechanism for the supervision and maintenance of fiscal discipline; with regard to this, although the 2005 “review” raised the SGP’s degree of flexibility, it does not seem to have been in a way that has strengthened its credibility, in particular in terms of its sanctionary nature, in view of the excessive number of causes that may allow it not to be applied. In this sense, an adjustment of the existing characteristics, namely considering a more restrictive and explicit list of “escape clauses”, together with the integration of some measures proposed over the last few years by different economists, including the proposal to evolve towards a pact based on public debt sustainability, as well as the inclusion of measures that could incentive coordination measures, would seem to be essential elements;

c) While a more significant expansion of the community budget is not possible, the effectiveness of the stabilising response to shocks of a specific or asymmetric nature may require a limited mechanism of shock absorption to be created.

Following Goodhart and Smith (1993), in order to be efficient and not to place excessive difficulties of implementation at various levels, such a mechanism should meet several requirements: firstly, it should be limited so that community action only occurs in the event of serious economic difficulties; secondly, it should be temporary so that it does not promote dependence and maintenance of the *status quo* rather than stabilisation, which means that its source of activation should only be negative changes in economic activity, and it should be suspended as soon as these changes cease; in the third place, its impact should only be produced during the stage of minor economic growth (and not extended beyond that), which means that the mechanism must be based on an indicator closely associated with fluctuations in real income; finally, there principle of subsidiarity should be effective, meaning that help should only occur where the deceleration of economic activity is caused by specific national factors.

In this context, it should also be noted that, since the beginning of the 90s, several attempts have been presented to create a "European scheme of fiscal transfers", which have been aimed at these kind of goals (*e.g.* Melitz and Vori, 1993; Italianer and Pisani-Ferry, 1994; Hammond and von Hagen, 1998). Although these have been unsuccessful in terms of policy adoption, some of them contain significant possibilities to be explored in the framework that we have just defended.

Also with regard to this, and in a similar way to that mentioned in section 2 relative to "income sharing mechanism(s)", if this transfer system existed, it should not be too extensive, otherwise it could put fiscal discipline at risk, by encouraging increasingly lax behaviour at the level of public accounts.

In addition, as a result of the lessons of fiscal federalism, evolution should be marked, at a more general level, by making legal provisions for a suitable and transparent sharing of competences at the various levels of government.

In this context, this would ideally result from a true European Constitution, which would fully provide for the principles of decentralisation and of subsidiarity, explicitly placing only the clearly supranational fields (e.g. defence, foreign policy, monetary policy and fiscal competition) as "federal" government competences.

In these fields, the unanimous decision rule should be replaced with a simplified rule of qualified majority: this would mean that decisions would be more likely to pass in the central organs of the Union and would reduce the possibility of creating blocking minorities, thus raising the Union's decision-making and intervention capacity, as well as contributing to a reduction in its "democratic deficit".

5. Conclusion

The objective of this paper has been to compare the present process of definition and implementation of fiscal policies in the EU with the main conclusions of the fiscal federalism theory, in order to draw possible lessons for the EU's future evolution, namely towards a possible "Federation of Nation-States".

This comparison supports the idea that the major conclusions of such theory are largely compatible with the emergence with a largely decentralised "Federation" in Europe, including the possibility of running significant positive welfare effects. However, the comparison also shows that there still a large gap between the present system and the one that would result from a large application of the fiscal federalism theory.

The gap is particularly relevant in the domain of macroeconomic stabilisation, where three elements should be stressed: a deficient definition and capacity of application of fiscal rules (even after the reform of the SGP); an insufficient degree of coordination of national fiscal policies; and a very limited financial autonomy for the centre, as the community budget has a very limited dimension. Also, the perspectives for the near future do not seem to include significant changes, as the failed Constitutional Treaty did not include important alterations in this field and the same seems to happen within the actual negotiations towards a "Reforming Treaty".

However, it seems to be arguable that it would be very important to modify this situation, with changes happening at two temporal levels: in the short-run, a strengthening on the coordination of national fiscal policies (requiring a marked change in its institutional framework), together with a credible reform of the SGP (as a relevant mechanism for the maintenance of fiscal discipline) and the creation of a limited mechanism of shock absorption (in order to increase the effectiveness of response to asymmetric shocks); in the medium to long run, a significant increase in the dimension of the EU budget, giving the EU a degree of financial autonomy compatible with the need to face new challenges and new demands.

In addition, as a result of the lessons of fiscal federalism, evolution should be marked, at a more general level, by making legal provisions for a suitable and transparent sharing of competences at the various levels of government. This would ideally result from a true European Constitution, which would fully provide for the principles of decentralisation and subsidiarity, explicitly placing only the clearly supranational fields (e.g. defence, foreign policy, monetary policy and fiscal competition) as "federal" government competences.

In these fields, the unanimous decision rule should be replaced with a simplified rule of qualified majority: this would mean that decisions would be more likely to pass in the central organs of the Union and would reduce the possibility of creating blocking minorities, thus raising the Union's decision-making and intervention capacity, as well as contributing to a reduction in its "democratic deficit".

The unsuccessful project of Constitutional Treaty included several changes that would put the present situation closer to the one defended in this paper, namely the elimination of the 3-pillar institutional structure, the increase in the number of areas with majority voting, the alteration on the rules for qualified majority or the attempt to present a distribution of competences between the Members and the Union.

It seems possible that some of these changes will be included in the "Reforming Treaty", now in negotiations. However, the inexistence of significant modifications in the economic field, the maintenance of some critical aspects of the Constitutional Treaty (Alves, 2007) and even the lack of transparency resulting from the negotiation process will still leave the situation far from what would be desirable.

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