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FISCAL POLICY CO-ORDINATION IN THE EUROPEAN UNION AND THE FINANCING OF THE COMMUNITY BUDGET

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1.- The constraints on fiscal policy in the EC Treaty

A central issue in the debate on institutional reform within the European Union is giving clear definition to the role that should be assigned to the budget, and to the main rules on fiscal policy. The topic is all the more significant given the advent of the Monetary Union and introduction of the euro, since the Treaty explicitly states (Article 105) that "the primary objective of the ESCB shall be to maintain price stability. Without prejudice to the objective of price stability, the ESCB shall support the general economic policies in the Community with a view to contributing to the achievement of the objectives of the Community as laid down in Article 2".

The Treaty also states (Article 99) that "Member States shall regard their economic policies as a matter of common concern and shall coordinate them within the Council". Thus an outright discrepancy appears between the goal of price stability and the other goals of economic policy: whereas the Central Bank is obliged to pursue price stability and may use all available instruments in order to achieve the objective established by the Maastricht Treaty, as far as the other goals of economic policy are concerned – most notably, output growth and full employment – all that is possible at the European level is co-ordination of decisions taken by national authorities.

Article 99 also defines the procedure that the Council may adopt to achieve co-ordination: "the Council shall, acting by a qualified majority on a recommendation from the Commission, formulate a draft for the broad guidelines of the economic policies of the Member States and of the Community". These guidelines will be discussed by the European Council, which, having deliberated on the matter, will adopt a recommendation setting out these guidelines. The Council will subsequently verify compliance with them by applying the mechanism of multilateral surveillance. This may lead to a recommendation, adopted by qualified majority, addressed to the Member State that has not fulfilled the obligations fixed by the Council. As an inducement for the Member State to comply, the Council may decide, acting on a qualified majority on a proposal from the Commission, to make its recommendations public.

It is evident that a recommendation addressed to a Member State and made public may have a moral suasion effect, especially as regards its impact on domestic policy. This has recently been exemplified by the Council's refusal to approve the recommendation proposed by the Commission, with regard to Germany and Portugal, that those countries should reduce deficits which the Commission deemed excessive. Nevertheless, it is also evident that European economic policy plays an entirely marginal role in achievement of the goals of economic growth and full employment.

Indeed, the main concern of the diplomatic endeavour behind the Treaty of Maastricht was to prevent divergent economic policy by a Member State from jeopardising the stability of the Monetary Union. The Treaty then introduced a no-bail out clause intended to exclude the possibility that national or local authorities might draw resources from the European Central Bank, but went on to stress (Article 104) that "Member States should avoid excessive government deficits". This provision of the Treaty has been further strengthened with adoption of the Stability and Growth Pact.

It should also be pointed out that, while Article 95 states that the Council adopts "the measures for the approximation of the provisions laid down by law, regulation or administrative action in Member States which have as their object the establishment and functioning of the internal market" in accordance with the co-decision procedure referred to in Article 251, the second paragraph of the same Article explicitly foresees that "paragraph 1 shall not apply to fiscal provisions", which must be adopted unanimously. Likewise, "for the harmonisation of legislation concerning turnover taxes, excise duties and other forms of indirect taxation", Article 93 states that the Council shall act unanimously after consulting the European Parliament and the Economic and Social Committee.

Unanimity is required where the competence of the Community in some specific sector is foreseen by the Treaty and fiscal measures must be introduced. In the environmental sector, for instance, the measures to be adopted in achievement of the objectives fixed by Article 174 must be decided in accordance with the co-decision procedure. Yet Article 175 explicitly states that the Council should take decisions unanimously when "provisions primarily of a fiscal nature" are at stake. The role of this provision regarding adoption of a CO_2/energy tax is well known. Although this tax was meant to be a major component of the strategy defined by the Commission to curb carbon dioxide emissions and limit the greenhouse effect, it has never been adopted, owing to the impossibility of achieving unanimity within the Council.

2. The constraints on management of Community budget

If the above are the main limitations on the management of fiscal policy, still more constrictive are the rules defined in the Treaty regarding use of the Community budget as an instrument of economic policy. Article 268 states that "the revenue and expenditure shown in the budget shall be in balance", thereby precluding change in the budget balance for anti-cyclical purposes. A further provision (Article 269) declares that "the budget shall be financed wholly from own resources" and defines the procedure for the creation of new resources: "the Council, acting unanimously on a proposal from the Commission and after consulting the European Parliament, shall lay down provisions relating to the system of own resources of the Community, which it shall recommend to the Member States for adoption in accordance with their respective constitutional requirements". Thus required for the creation of new own resources is not only the unanimous consent of all the Member States but also the time-consuming procedure of national ratifications.

A further limitation on the use of the budget as an economic policy instrument derives from its size. The general budget of the European Community for the year 2002, adopted after the second reading by the European Parliament on 13 December 2001, made payments appropriations amounting to €95.7 billion, equal to 1.03% of the Community's GDP, an all-time minimum which fell €4.6 billion short of the maximum – 1.14% of GDP – envisaged by the Financial Perspective, which is a genuine multi-annual financial framework**.** As regards commitment appropriations, 45.2% was allocated to agriculture, 34.5% to structural and regional policies, 8.4% to external aid, 5.2% to administration, 4.1% to research and technological development, while the remaining policies – environment, energy, consumer protection, internal market, industry and trans-European network – received only 2.6%. It is evident from these figures that:

a) the size of the budget prevents its effective use as an economic policy instrument because variations – even large ones – in expenditure flows cannot have a significant anticyclical impact. The same applies to revenue changes, since own resources are of limited size and have scant flexibility *vis-à-vis* variations in output;

b) expenditure is intended to guarantee the financing of common policies – but with a large share of the budget absorbed by agricultural policy, this being the first to be implemented at the Community level – and redistribution in favour of less developed regions, given that 63% of Structural Funds is targeted on the development of least favoured regions (Objective 1). More recently introduced policies – environment, research and technological development, industry, trans-European networks – only receive marginal resources.

Hence, the present size of the budget does not permit significant development of the second pillar in order to comply with the objectives set by Article 2 of the Treaty on European Union, namely that the Union must "assert its identity on the international scene, in particular through the implementation of a common foreign and security policy including the progressive framing of a common defence policy, which might lead to a common defence".

Further critical remarks can be made concerning the composition of own resources. The Treaty assumes (Article 269) that the budget will be wholly funded by own resources. Indeed, following the decisions taken by the European Council in Berlin on 24-25 March 1999, the most significant source of revenue in the 2002 budget was the Fourth Resource (43.0%), which is a contribution linked to the size of each Member State's GDP, whereas the share of VAT was reduced to 38.3%. The other traditional own resources accounted for 16.6%, with a residual 2.1% being represented by various revenues and surpluses carried over to the 2002 budget from the previous year. On the revenue side, greater proportionality between revenues and GDP was achieved in Berlin, but the principle that the budget should be financed with own resources seems to have been largely disregarded.

3.- The co-ordination of fiscal policy

The limits on fiscal policy that emerged with the Maastricht Treaty have been further amplified by the approval of the Stability and Growth Pact. This Pact has increased the rigidity of fiscal policy because it requires that, even during a recession, the deficit of a Member State's budget may not exceed 3% of GDP, and it has established, as a medium term goal, a balanced – or close to balance – budget. This constraint further restricts the scope for autonomous stabilisation policy within the national framework, and even more so if a Member State hit by an exogenous shock is already close to the deficit limit set by the Pact (Petretto [2002]).

In the past, the proposal to create a European Unemployment Fund has been put forward in order to overcome this limitation. This idea, first advanced in the MacDougall Report (European Commission [1977]), has been recently renewed, the intention being to provide an automatic stabilisation mechanism at the European level whereby a Member State faced with an increase in unemployment during a recession will automatically receive larger transfers from the Fund to help reverse the cyclical downturn. The conditions today, however, are rather different from those which obtained when the MacDougall Report was published. Maastricht has consequently adopted a different approach which takes account of the fact that an increase in the size of the budget at the European level would be impracticable in the present political climate.

This solution is innovative, but it has also a significant shortcoming (Majocchi [1999]). The co-ordination model of fiscal policies adopted in Maastricht is important because it does not require the complete transfer of stabilisation policy to the European level; rather, it leaves the main responsibility for it to the national authorities and only requires that co-ordination of fiscal policies be ensured by the European level. This co-ordination should avert the risk of unsynchronised stabilisation policies – so that one Member State is pursuing an expansionary policy while another is reducing the level of demand – and should steer national fiscal policies towards convergent goals by means of the multilateral surveillance mechanism.

This appears to be a significant deviation from the theoretical model of fiscal federalism, which requires the assignment of responsibility for stabilisation policy to the central tier of government (Oates [1972]). The European experience differs from the majority view in the literature, in that it has not been considered necessary to transfer the direct management of stabilisation policy to a higher level. This responsibility is left to the Member States, although effective co-ordination should be guaranteed at the European level. In principle, while this innovation should be judged positively because it strengthens the federalist character of economic policy, it should be stressed that the Maastricht model comprises a major flaw: co-ordination should be ensured by the Council, but this can only make non-binding recommendations to the Member States, which are not obliged to comply with European prescriptions.

Furthermore, European-level decisions in this field should be taken unanimously. Yet this rule is unable to ensure either democracy or decision-making efficiency. In a confederal system like the one that still prevails in the fiscal sector, where the veto principle applies and co-ordination is not supported by effective powers assigned to the higher tier of government, the result is not an effective European economic policy, but rather a sum of different national policies unable to ensure the economic policy that Europe needs. Monetary Union should then be backed by an effective Economic Union able to promote the growth of output and employment and the achievement of the other goals of economic and social policy foreseen by Article 2 of the Treaty.

4.- *Stabilisation of the European economy*

Once the need to manage a stabilisation policy has been recognised, two different problems arise which must be carefully distinguished within the framework of an Economic and Monetary Union. The first is how to achieve macroeconomic equilibrium at the level of the Community as a whole through the efficient combination of fiscal and monetary policy measures, given that monetary policy in the Monetary Union is now directly managed at the European level. The second problem is ensuring the stabilisation of macroeconomic variables in each Member State, now that the exchange rate instrument has been abandoned with the creation of the European currency.

As regards stabilisation of the European economy, the kind of fiscal policy adopted is particularly important, for the Statutes of the European Central Bank clearly state that the primary task of monetary policy is to promote price stability. In the framework of fiscal policy, the main issue is establishing whether stabilisation is to be achieved by a manoeuvre involving a change in the Community budget or by the co-ordination of Member States' fiscal policies.

In all existing federations, the task of macroeconomic stabilisation of the economic system as a whole is assigned to the central tier of government. Theoretically, the main justification for the allocation of this task to the federal level is the existence of externalities. In an open economy, a relevant share of public spending benefits non-residents through a change in imports, while residents bear the cost through the heavier future taxes levied to fund the increased public debt. As always happens if externalities are not internalised, governments in small open economies are likely to feel themselves unable to undertake as much stabilisation as would be optimal. This is because the more the benefits of regional stabilisation efforts spill over to other regions, the smaller the incentive for the regions to use them, since they have to bear the full burden in higher debt or tax rates.

Today, there is substantial agreement among economists that stabilisation policy should be assigned to the central level of government, as suggested by Musgrave [1959] in his theory of the allocation of the public sector's economic functions. This line of thought was reprised by the MacDougall Report (European Commission [1977]), which pointed out that "the prima facie case for an increasing Community involvement in the general regulation of economic activity is based on the increasing interdependence of national economies, through increasing trade, capital flows and internationally transmitted inflation. The more open the economies of Member States in all these respects, the less effective national instruments of economic policy become. Multiplier effects on internal demand of tax or expenditure changes are dampened by a high propensity to import. The presumed remedy is to pursue the objectives at a higher level of government with a broader jurisdiction encompassing major spillover or leakage effects, either through co-ordination or direct fiscal action. However, any proposal for direct fiscal action for this purpose at the Community level encounters two major issues, the interrelation with monetary policy and the question how to achieve adequate scale of operation".

The first issue raised by the MacDougall Report with regard to the assignment to the Community of responsibility for stabilisation policy appears irrelevant in the framework of the Economic and Monetary Union, since monetary policy is now a European concern. But the second issue remains: effective management of European-level fiscal policy for stabilisation is still difficult because of a specific characteristic of the Community's situation compared to other federations: the predominant weight – in total public spending – of the expenditures included in the budgets of Member States compared to the Community's expenditures, which represent only 1.03% of the Community's GDP. The MacDougall Report remarked that "as to the question of critical scale of fiscal action, the small size of the Community budget in the 'status quo' and 'pre-federal stage' implies that in order to have a perceptible macroeconomic effect on the Community economy as a whole, the budget balance would have to swing by enormous percentage fractions of this budget –e.g. 50%".

Generally, given the present size of the budget and the constraints attendant on it – prohibition on running a budget deficit (Article 268), lack of flexibility due to the multi–annual financial planning foreseen by the 1988 agreements on budget discipline – the

Commission's role in the management of stabilisation policy is usually considered to be limited to the co-ordination of Member States' fiscal policies.

Co-ordination is absolutely necessary even if responsibility for fiscal policy rests directly with the central tier of government, since perverse effects with respect to the achievement of stabilisation goals should be avoided by preventing pro-cyclical behaviours in budget policy by Member States. But in the EMU, co-ordination is the only instrument with which to counter symmetric shocks hitting the entire European economy. This has two consequences. Firstly, the effectiveness of the Stability Pact rules that require a balanced or close to balance budget should be questioned. At Member State level, anti-cyclical changes in the budget balance – with the ensuing emergence of surpluses during booms and of deficits during slumps – should become more frequent, now that it is impossible to use the monetary policy instrument and with responsibility for stabilisation policy transferred to the Member States. Secondly, Member States have grown less inclined to pursue stabilisation policies as external effects have become more marked following completion of the Internal Market. Lastly, and this seems to be the decisive point, the effects of a discretionary policy, based on the co-ordination of fiscal measures adopted by Member States, arise with such a time lag that the stabilisation prospects of this policy are nullified.

Hence, the co-ordination of fiscal policies implemented by Member States is a necessary but insufficient condition for the effectiveness of a Community stabilisation policy intended to deal with symmetric shocks affecting the whole European economy to a macro-economically significant extent. In this regard it seems useful to recall the EMS, since at that time there already appeared an asymmetry in the effects of fiscal policy and a strong deflationary bias. When it was necessary to adopt restrictive measures to curb the inflationary effects, for instance, ensuing from an exogenous shock on inputs costs, each Member State was prone to increase tax rates or to reduce expenditures without taking account of the deflationary effects induced by similar measures in the other countries. The risk of overshooting derived from determination to achieve the goal in any case, whatever the behaviour of the other Member States. In the case of negative exogenous shocks on demand – for instance following restrictive policy measures by the United States or Japan – implementation of expansionary policies was more difficult, either because the benefits of fiscal policy were largely lost due to the existence of spillovers, or because it was feared that playing the role of first mover would yield benefits for the partners acting as free riders.

Co-ordination is certainly able to reduce the probability that a deflationary bias will arise in the management of fiscal policy by the Member States, but given the time delays that characterise the political decision-making necessary to implement co-ordination, overshooting is still possible in the case of both automatic stabilisation or discretionary fiscal policy measures. Furthermore, it should be stressed that, as regards the political process involved in taking an effective decision, the strongest Member States indubitably exert the greatest influence on the definition of co-ordinated fiscal policy measures – as is normally the case in all political structures of a confederal nature. It would therefore seem rather unlikely that the weaker – economically and politically – Member States would proceed in this direction with any great enthusiasm.

Hence, the conclusion therefore seems to be that the EMU, in a political framework evolving towards federalism, should acquire the capacity to promote an autonomous stabilisation policy through a series of adequate reforms in the field of budget policy. These reforms should at least include:

a) enlargement of the budget's size, which is in any case unavoidable also for allocative purposes;

b) a change to the budget's rules allowing compatibility with price stability, but at the same time ensuring greater flexibility in the use of resources;

c) the creation of revenue sources to guarantee some automatic flexibility on the revenue side.

However, the prerequisite for implementation of these reforms is a strengthening of the responsibilities of the budgetary authority represented by the European Parliament and the Council of Ministers. This authority should be empowered to decide on how Community expenditure should be financed. At present, with a political structure within the Community of confederal nature, the containment of Community expenditures is guaranteed by rigid rules on budgetary discipline, while decisions regarding the revenue side of the budget must be taken unanimously. But in a federally-oriented Union – like the one that will eventually emerge from the constitutional work of the European Convention summoned by the Laeken European Council – the budgetary policy as a whole, on both the revenue and expenditure sides, will be governed by joint decisions taken by the two branches of the budgetary authority, and within the framework of the Treaty's provisions setting rigid limits on fiscal policy in the EMU.

5.- Asymmetric shocks and the European Stabilisation Fund

The main limits on stabilisation policy derive from the fact that adjustment mechanisms in a Monetary Union should be linked to a federal budget able to cope with either a general shock hitting the whole Union or a country-specific shock with asymmetric effects on different Member States. This is the predominant view in the literature on stabilisation policy. It accordingly seems reasonable to endow the Community budget with a built-in insurance mechanism to deal with asymmetric shocks. This mechanism should provide additional resources to Member States hit by the shock, thereby off-setting the negative effects which worsen the budget balance endogenously, and permitting compliance with the rules of financial equilibrium established by the Stability Pact or promoting the growth of the economy hit by the recession.

A Report (European Commission [1993]) prepared by a group of experts for the European Commission has proposed (Majocchi-Rey [1993]) the creation within the Community budget of a Stabilisation Fund comprising resources transferable to a Member State hit by an asymmetric shock. The mechanism should operate automatically, without previous discretionary evaluation, thereby preventing the pro-cyclical effects that might arise from the transfer due to the time taken to reach a decision so that the expansionary measure exerts its effects only when the recession has passed.

Financial support for the country hit by the exogenous shock should take the form of an unconditional transfer, not a refundable grant. In this way the beneficiary economy will not have to bear the burden of debt repayments during the expansionary phase. This Stabilisation Fund, endowed with ad hoc funding, should consist of a reserve within the Community budget, and the criteria for assuming the existence of an asymmetric shock should be specified. The idea put forward in the Report is that an asymmetric shock can be deemed to exist when there is a positive difference between the change in a Member State's unemployment rate and the Community average. The use of this parameter has the major advantage that the figure relative to the unemployment rate is available with a short delay of only some months, and it is relatively harmonised on a European scale. However, another parameter could be adopted provided it is sufficiently harmonised and available with no time lag.

According to the Report, the stabilisation mechanism should provide a transfer equal to 1% of the GDP of the Member State hit by the asymmetric shock for each percentage point of difference between the Member State's unemployment rate and the European average. However, an upper limit on the transfer equal to 2% of the GDP of the country concerned is suggested in order to curb the flow of transfers, and accordingly the size of the Fund. Hence, the transfer could increase up to the maximum of a 2% difference between the unemployment rate and the Community average.

The procedure for defining the amount of the transfer payments is relatively straightforward (Majocchi [1993]). On the basis of $U_i(t)$, which is the national unemployment rate of Member State *i* in month *t*, the Community average excluding the Member State itself, $U_{iEC}(t)$, is calculated for the same month. The change in the unemployment rates with respect to 12 months previously is then calculated as follows:

$$dU_i(t)= U_i(t) - U_i(t-12)$$

$$dU_{iEC}(t) = U_{iEC}(t) - U_{iEC}(t - 12)$$

In this way, seasonal variations are eliminated in the definition of changes in the unemployment rates.

A Member State would receive a transfer if the 12-month change in its unemployment rate is positive and greater than the average of its Community partners

$$dU_i(t) > 0$$

$$dU_i(t) > dU_{iEC}(t)$$

With a full stabilisation mechanism, it is not necessary to achieve a threshold, i.e. a minimum variation in the unemployment rate, before the mechanism comes into operation, and each percentage point difference with respect to the change in the average of the Community partners – excluding the Member State itself – implies a monthly payment equal to a parameter α, assumed equal to 1% of the GDP of the Member State undergoing a cyclical downturn.

Moreover, in order to impose an upper ceiling on the amount of the transfer, and then on the overall amount of the Fund, relative unemployment changes of more than two percentage points will no longer be compensated. The maximum monthly payment to a member State is therefore equal to 2% of one twelfth of its annual GDP (see Figure 1).

Hence, the complete stabilisation mechanism implies the following rules:

$$T_i(t) = 0 \qquad \text{if}$$

$$dU_i(t) - dU_{iEC}(t) \leq 0$$

$$dU_i(t) \leq 0$$

$$T_i(t) = \alpha\, [dU_i(t) - dU_{iEC}(t)]\, Y_i \qquad \alpha = 1 \text{ if}$$

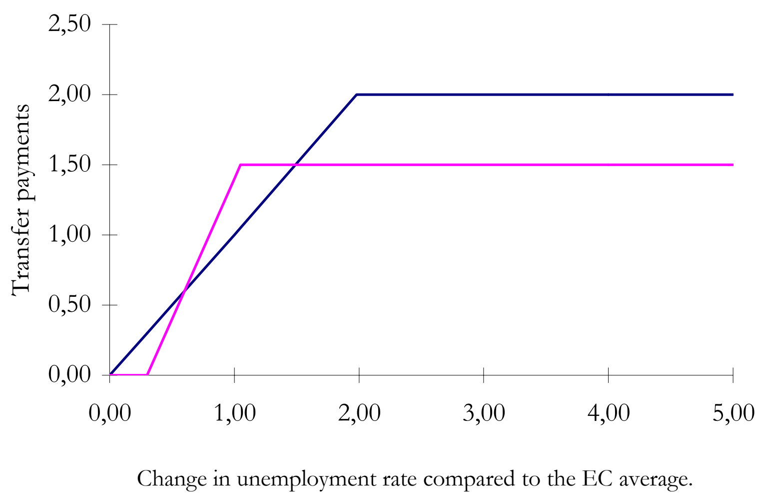
$$0 < dU_i(t) - dU_{iEC}(t) \leq 0.02$$

$$T_i(t) = \alpha\, (0.02)\, Y_i \qquad \text{if}$$

$$[dUi(t) - dUi_{EC}(t)] > 0.02$$

With a stabilisation mechanism endowed with these characteristics "it is clear that a degree of stabilization comparable to that in the United States could be obtained, depending on the size of the payment and the method used. Assuming a payment equal to 1% of GDP on annual basis, the degree of stabilization of the proposed system can be assumed to be in the range of 18 to 19%" (Italianer-Vanheukelen [1993], p.499). Furthermore, by means of a simulation of the functioning of the scheme for the period 1984-1991, it has been estimated that the maximum amount of transfer payments effected by the Fund on an annual basis will be an average of €11.2 billion, equal to 0.23% of Community GDP in the year 1990.[1]

Fig.1. *Transfer payments and change in unemployment rate compared to the EC average.*



A limited stabilisation mechanism could be devised to ensure that payments are only made if the asymmetric shock is above a minimum threshold, which in this case could be an unemployment change relative to the Community partners average equal to 0.3%, although parameter α could be set at 2% (instead of the 1% for the full stabilisation mechanism). The maximum amount received by a Member State in one month would then

[1] By way of comparison, in the decade 1980-1990 the total amount of transfers in the framework of the *Finanzausgleich* scheme in the Federal Republic of Germany (obviously including only the Western *Länder*) accounted for 0.15% of domestic GDP (Italianer-Vanheukelen [1993], p. 499).

be set equal to 1.5% of one twelfth of annual GDP in the country hit by the exogenous shock. Hence, when the change in the unemployment rate compared to other EC countries reached 1.05 percentage points, the transfer payment would not increase any further, and the degree of stabilisation would decrease from its maximum. The following rules are implemented in this scheme:

$T_i(t) = 0$ if

$$dU_i(t) - dU_{iEC}(t) \leq 0.003$$

$$dU_i(t) \leq 0$$

$T_i(t) = \alpha\,[dU_i(t) - dU_{iEC}(t) - 0.003]\,Y_i \qquad \alpha = 2$ if

$$dU_i(t) - dU_{iEC}(t) > 0.003$$

$$\alpha\,[dU_i(t) - dU_{iEC}(t) - 0.003] \leq 0.015$$

$T_i(t) = 0.015\,Y_i$ if

$$\alpha\,[dU_i(t) - dU_{iEC}(t) - 0.003] > 0.015$$

With use of this limited stabilisation mechanism the degree of stabilisation in the regional economy hit by the exogenous shock is even higher, varying according to different estimates between 25.6% and 27.7% (Italianer-Vanheukelen [1993], p.503). This mechanism therefore guarantees an adequate level of stabilisation for asymmetric shocks exceeding the minimum threshold. A simulation conducted for the period 1984-1991 has shown that on average the Fund's total expenditure varied between 0.21% and 0.22% of Community GDP.

In conclusion, it seems possible to devise a stabilisation mechanism able to ensure the same level of stabilisation achieved in the United States through the automatic flexibility of the budget (Pisany-Ferry *et al.* [1993]), at a cost to the Community budget which has been estimated as no higher than 0.2% of GDP (Italianer-Vanheukelen [1993]). Although simple to implement, this mechanism does not seem biased by the usual flaws of stabilisation mechanisms: shock identification difficulties, delays in starting up the mechanism, possibility of pro-cyclical behaviours.

Furthermore, the scheme, which is implemented through intergovernmental transfers, does not produce the disincentive effects on individual labour supply usually associated with insurance mechanisms against unemployment, even if the start-up of the scheme is tied to changes in unemployment rates.

6. Financing the Community budget with a surtax on national income taxes

The MacDougall Report (European Commission [1977]) already underlined the need to increase the size of the Community budget to at least 2-2.5% of European GDP during the so-called pre-federal stage. A budget of this size "could reduce inequalities in living standards between member states by about 10%, compared with the average of about 40% in the countries studied, and might be judged an acceptable start". A larger budget – equal to 5-7% of GDP – "could provide sufficient geographical equalisation of productivity, living standards and cushioning of temporary fluctuations to support a Monetary Union". Given the present political climate, it seems reasonable to assume that doubling the present size of the budget – as would be necessary to comply with the suggestions of the MacDougall Report during the pre-federal phase – is the maximum that could be achieved. Similar conclusions have been reached by a recent Report on the role of Community public finance in the Monetary Union prepared by a group of experts for the European Commission (European Commission [1993]). The problem is therefore that of finding new resources with which to fund the increase in Community expenditure.

First, it seems useful to examine the idea of financing future increases in Community expenditure by a new European surtax levied on top of the revenue taxes already existing in the member States, using a simple redistributive mechanism (Majocchi [1993]; Majocchi-El Agraa [1983]). Creation of this Community surtax entails reform of the present fourth resource, significantly increasing its redistributive impact and, to some extent, also its stabilisation effects. Under the proposed mechanism, the total revenue to be supplied by this surtax – defined, in like manner to the fourth resource, as the residual difference between Community expenditure and the revenue of the other traditional own resources – is initially distributed among the Member States according to the relative share of each country's GDP in Community GDP. The amount of resources that each Member State is obliged to pay to the Community budget is then modified by applying a progressivity coefficient estimated according to the ratio between the per-capita income of that country and average European per-capita income. In this way the richest countries would pay more to the Community budget than the less rich Member States. Lastly, each Member State would have its citizens pay the Community surtax according to the provisions that govern its own national income tax system.

T_E is the total revenue that should be provided by the fourth resource. It is initially distributed among the Member States according to the share of each country's GDP in European GDP. If t_a is the proportional rate defined at the Community level – equal to the share of its own GDP that each country must pay to the Community budget – and Y is the income (Y_E being the total Community income), then

$$T_i = t_a Y_i \qquad (1)$$

with

$$T_E = \Sigma T_i = t_a Y_E \qquad (2)$$

and, given that the tax is proportional to GDP, for each Member State *i*

$$q_i = T_i / T_E = Y_i / Y_E \qquad (3)$$

Equations (1)-(3) describe the present system of the fourth resource. This distribution of the tax burden devoted to financing the Community budget can be progressively changed by introducing a correction which represents the relative degree of prosperity for each Member State, so that the richest countries pay more and the poorest less.

If q_i^* is the share of the total fiscal revenue due by each country i following the correction with a progressivity coefficient k_i, then

$$q_i^* = T_i^*/T_E = k_i T_i / \Sigma k_i T_i$$

where the progressivity coefficient, N being the population, is represented by

$$k_i = (Y_i/N_i)/(Y_E/N_E).$$

Given that

$$T_i^* = q_i^* \, T_E = t_{ai}^* Y_i \qquad (4)$$

on the basis of (1)-(4), the new effective tax rate is

$$t_{ai}^* = T_i^*/Y_i = (q_i^* \, T_E)/Y_i = q_i^* \, (t_a \, Y_E)/Y_i = t_a \, (q_i^*/q_i)$$

and the ratio between the progressive and the proportional rate is

$$t_{ai}^* / t_a = q_i^*/q_i$$

Hence, if k_i is moving towards 1 because the gap between per-capita income in country i and the European average is diminishing, then q_i^* is also moving towards q_i and the tax rate will over time be inclined towards proportionality. The amount of the Community surtax will then diminish in the rich countries and increase in the poor ones if the gap in income levels narrows. Eventually, if a complete levelling of per-capita incomes occurs, the Community budget will be entirely financed by the traditional own resources and by a proportional tax with a constant rate, that is, by means of a system quite similar to the present one of the fourth resource.

When the total amount of money that a country i must pay to the Community budget has been defined, the system that could be adopted in order to allocate this tax burden among its citizens – maximising in the meantime the transparency of the Community budget's funding – seems to be the one whereby each Member State distributes the fiscal burden among its citizens by imposing a surtax on income tax, keeping the structure of the national income tax system constant (Majocchi [1987]). The rate of this surtax levied to fund the Community budget can be assessed as follows. If

$$T_i^* = t_{ai}^* Y_i$$

and the revenue from personal income tax in country i is

$$R_i = r_i \, Y_i \qquad (5)$$

then

$$Ti^* = (t_{ai}^* / r_i) \, R_i \qquad (6)$$

Hence, the surtax rate for each taxpayer in country i will be t_{ai}^*/r_i. Of course, implementation of this surtax will not alter the shape of the progressive income tax function adopted in each country, nor the degree of progressivity defined according to the national social welfare function.

Table 1 compares the present system of financing the Community budget (in 2001) through the fourth resource against the proposed system with a fourth resource corrected with a progressivity index. Column (1) shows the present distribution of the fourth resource's revenue – proportional to the GNP of Member States and with a rate equal to 0.399% in 2001 – while column (2) indicates the relative contribution of each country to the total revenue of the fourth resource. Column (3) gives the progressivity index k_i measured by the ratio between the per-capita income of each country and average Community per-capita income (evaluated with a Purchasing Power Standard). This index is used to adjust the revenue of the fourth resource for each country as it appears in column (1). Column (4) evaluates the share of each country in the total of the revenue adjusted with the progressivity index and, applying its share to the expected total revenue, determines the revenue flowing from each Member State according to a progressive distribution of the tax burden (column 5), while in Figure 2 this revenue is compared to the revenue of the fourth resource. Column (6) shows the change in the national contribution of each Member State to the Community budget (Figure 3). Column (7) estimates the rate for each Member State (Figure 4), which differs significantly from the common rate of the fourth resource – equal to 0.399% in 2001 – while the adjusted new rate varies in range between 0.72% for Luxembourg and 0.28% for Greece.

Tab.1. *System of financing the Community budget.*

	(1) Fourth Resource (million €)	(2) % Revenue	(3) K_i	(4) % Revenue	(5) Progressive Fourth Resource	(6) Revenue Change	(7) Progressive Rate
Austria	859,788	2,444	108,4	2,600	914,617	54,829	0,424
Belgium	1066,573	3,032	110,2	3,279	1153,473	86,901	0,432
Denmark	692,430	1,968	120,2	2,322	816,824	124,393	0,471
Finland	544,478	1,548	101,9	1,548	544,549	0,071	0,399
France	5753,927	16,357	98,8	15,858	5578,463	-175,464	0,387
Germany	8377,646	23,815	103,8	24,257	8533,028	155,382	0,406
Greece	524,662	1,491	69,8	1,022	359,515	-165,147	0,273
Ireland	421,475	1,198	121,6	1,430	503,040	81,565	0,476
Italy	4844,650	13,772	101,5	13,717	4825,310	-19,340	0,397
Luxembourg	81,625	0,232	201,1	0,458	161,113	79,488	0,788
Netherlands	1715,367	4,876	116,1	5,555	1954,115	238,749	0,455
Portugal	476,610	1,355	74,3	0,988	347,555	-129,056	0,291
United Kingdom	6314,319	17,950	104,6	18,424	6481,120	166,801	0,410
Spain	2539,527	7,219	82	5,809	2043,466	-496,061	0,321
Sweden	964,515	2,742	101,7	2,736	962,459	-2,056	0,398
EC	35177,6	100		100,00	35177,6		

Fig.2. *Fourth resource and progressive fourth resource compared.*

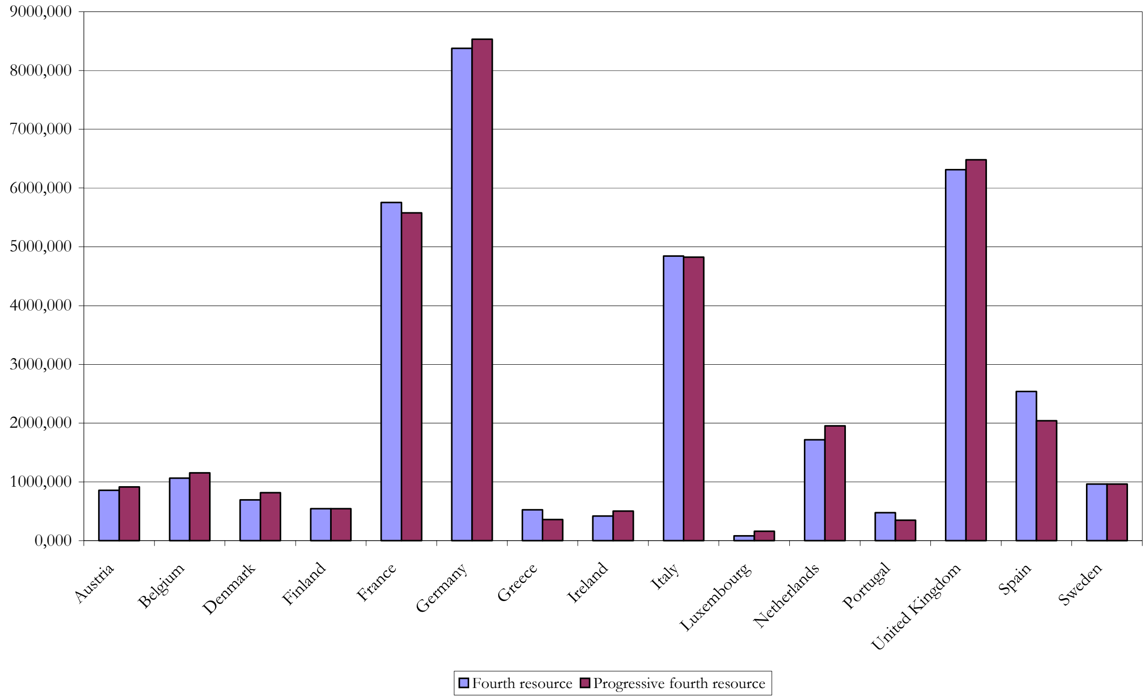


Fig.3. *Change in the national contribution of each Member State.*

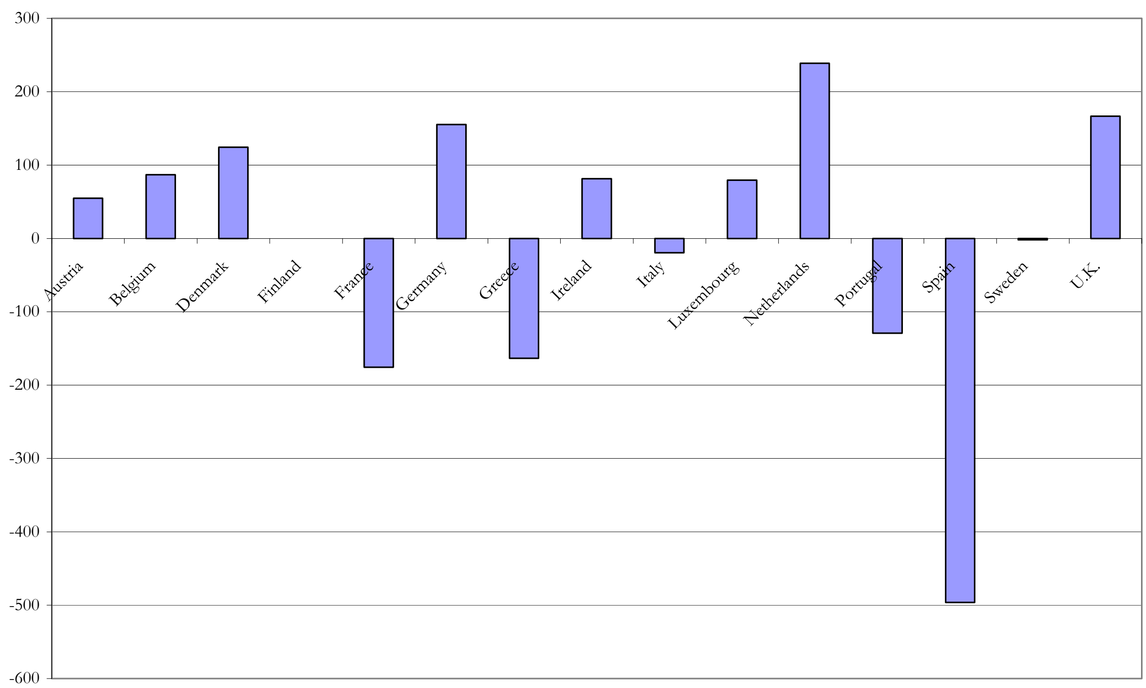
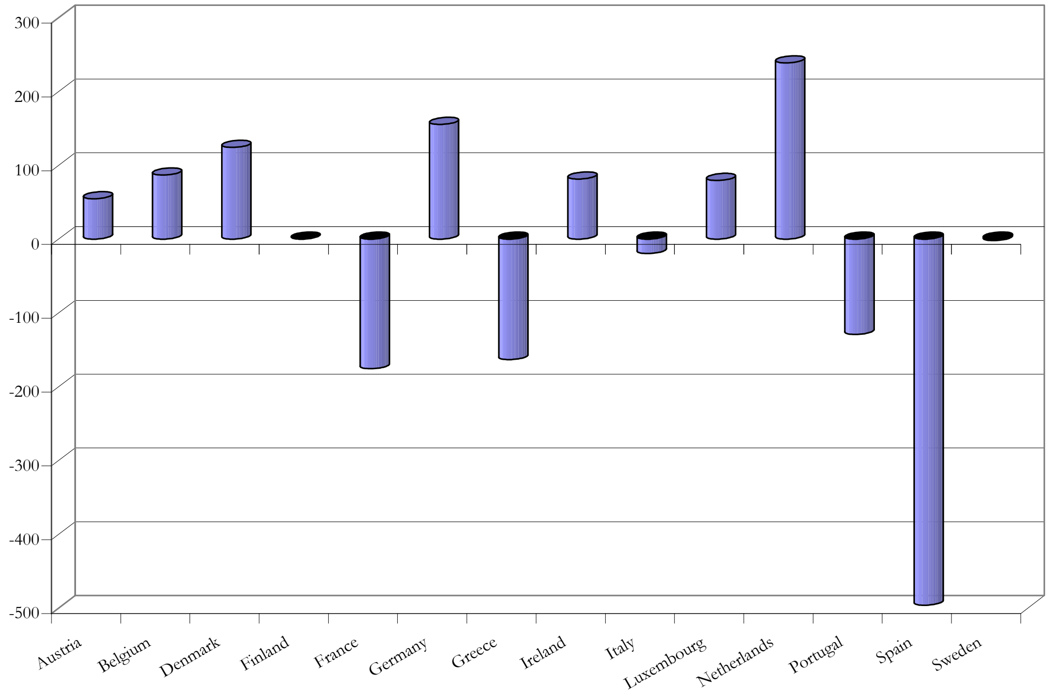


Fig.4. *Progressive rate of each Member state.*



As far Italy is concerned, the total contribution remains practically unchanged. In determining the rate of the surtax, first equation (5), with R_i (the revenue from personal income tax, Irpef) in 2001 equal to € 9.4 billion and Y_i (Italian GDP in 2001) equal to €1216.6 billion, yields r_i – that is, the average rate of income tax – as 9.81%. Hence, according to equation (6), the surtax rate levied on the top of Italian progressive income tax – and paid by each taxpayer in Italy proportionally to her/his tax burden – will be 4.035%.

7.- The theory supporting the surtax and the model of fiscal federalism

The model of fiscal federalism normally referred to in the literature is that initially developed by Musgrave [1959] and further elaborated by Oates [1972]. In this model the redistribution function must be centralised because personal mobility, which is increasing with diminution of the size of the territory concerned, may cause locally managed redistribution policy to fail. In fact, poor taxpayers will have a strong incentive to move to areas where redistribution measures are substantial, with subsidies for less favoured income earners and high rates of taxation on the highest incomes, whilst the rich will concentrate in areas where redistribution policy is weaker. As a consequence, financial resources will be depleted in areas with an effective redistribution policy, since expenditure is very high while the tax base shrinks, whereas in the most favoured areas the budget will be in huge surplus because the tax base has been broadened.

This theoretical scheme is contradicted by the present assignment of economic functions within the European Union (Tabellini [2001]), because redistribution policy is, and probably will remain in the foreseeable future, a competence of the Member States, and not of the Union. In the literature, since the well-known paper by Pauly [1973] on redistribution as a local public good, theoretical reasons have been put forward in support of this choice, while in Europe the assignment seems reasonable owing to the wide differences still persisting at the national level among preference functions concerning the optimal level of redistribution. This reasoning has been further developed by Tresch [1981], who assigns the task of income redistribution among different regional areas to the central tier, while the lower levels of government keep responsibility for interpersonal redistribution (Tresch [1981]; Majocchi [1987]; Petretto [1987]).

The Tresch model assumes that the welfare level of local and regional governments is affected only by the utilities of the individuals resident within their jurisdictions, excluding any linkage among the welfare functions of different areas. It also assumes that individuals' utilities depend only on the goods that they consume, excluding any externalities. By contrast, the welfare of the central government is related only to the welfare of the lower tiers of government, measured according to their own welfare functions and dependent on the utilities of their citizens. The assignment of the redistribution competence is radically modified with respect to the traditional model by the constraint – with which the central government is obliged to comply – of non-interference with the welfare functions of local governments and by the assumption of the lack of interdependence and externalities: only the local governments redistribute income among individuals according to their own preferences, while the central government uses lump-sum transfers to equalise the incomes of different regions according to its own welfare function (Tresch [1981]; Rimini [1993]).

This model seems to provide adequate theoretical support for the proposal to finance the Community budget with a surtax on top of the national personal income taxes levied by each Member State within the European Union. The Community surtax levied according to the level of GDP of each Member State, but with a rate corrected with a progressivity index, fulfils the task of income redistribution assigned to the central government, while the national surtax, which does not interfere with the progressivity scale characterising each national income tax system, is related to the redistribution task assigned in the Tresch model to the local authorities according to their own preferences (Rimini [1993]).

From the point of view of the effectiveness of fiscal policy, the advantages of this scheme can be summed up in the following three points:

a) transparency of the tax: citizens know the fiscal burden linked to the funding of the Community budget. This point becomes important if the size of the budget is expected to increase significantly in the future;

b) redistribution effects: this kind of taxation has a positive redistribution impact (Majocchi [1985]; Rimini [1993]) on the various areas within the Community that do not have homogenous levels of economic development, and it may represent a first step towards a European *Finanzausgleich* system, a step that seems unavoidable if the Community is going to evolve into a federal Union;

c) stabilisation effects: a tax related to income level strengthens the automatic stabilisation properties of the budget. The measure of the stabilisation effects depends significantly on the amount of total revenue and the technical characteristics of the tax, if the latter is structured so that the time lag between income and tax changes is minimised. A further advantage of this proposal is that it does not require previous harmonisation of existing national laws on income taxation.

8.- The future of the Community budget

A small increase in the size of the budget – equal to 0.2% of the Community GDP – targeted on financing a European Stabilisation Fund will be sufficient to insure each Member State against the risks of a recession following an asymmetric shock, and to prevent an increase of the country's budget deficit due to the ensuing fall in income, which will automatically bring about a diminution of receipts and an increase in expenditures. The difficulty of acquiring new resources for the European budget is well known – even if those resources could be balanced by a cutback in the resources devoted to national budgets deprived of the need to support stabilisation policy in the case of a country-specific shock. But the real issue is completion of the Economic and Monetary Union by providing effective government of the European economy.

The Commission's *Agenda 2000* (European Commission [1999]) does not foresee an increase in the size of the Community budget, not even in view of enlargement. None the less, a decision providing new fiscal resources for the Union seems unavoidable, not only to start up the Stabilisation Fund but also to strengthen the new policies necessary to achieve the strategic goal set for the Union over the next decade by the Lisbon European Council (23-24 March 2000): "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 particular, urgently needed is accomplishment of the project set out in the Delors White Paper (European Commission [1993]), which foresaw the implementation of a new growth model guaranteeing the absorption of the excess labour supply and reducing the excessive use of natural resources through fiscal reform based on higher environmental taxes and a reduction of social contributions – keeping the overall fiscal burden constant – the goal being to promoting employment (Majocchi [1996]). An expansion of Community public expenditure should back these structural measures to create the new infrastructures – in particular, trans-European networks – needed for real completion of the internal market.

If more resources are necessary to implement the Delors Plan, even further resources are needed to accomplish the second pillar, especially if a positive decision is taken regarding European defence, which is a *sine qua non* for an effective European foreign policy. There is now broad consensus on this matter after recent events in the Balkans and in the Middle East, with their negative effects on European security. But if a European defence force is to be assembled, adequate expansion of the Union's budget will be necessary and new resources will have to be found.

9.- Fiscal policy rules in the new European Constitution

The Convention summoned by the Laeken European Council should undertake the urgent task of introducing the constitutional reform necessary to ensure both the democracy and efficiency of the European institutions. The basic problem in the fiscal field is quite simple. The budget should be used effectively for: a) allocative purposes: new policies to protect the environment and promote the research and technological development needed to secure the productivity increases able to ensure the competitiveness of European products, new expenditures to create a European defence force; b) stabilisation purposes: creation of a European Stabilisation Fund and an adequate own resources structure able automatically to stabilise the Member States' economies and which could be used to counteract exogenous shocks hitting the whole European economy.

If this outcome is to be achieved, the new Constitution must give effective governing power to the Commission, implicitly recognising the Union's role as a federal State. Hence, the Commission should be given genuine executive powers, and the Council, transformed into a Chamber of the States (a Senate) like those usual in federal systems, should take decisions in all fields, including the fiscal one, on a majoritarian basis, thereby definitively abandoning the unanimity rule with the consequent power of veto.

Particular rules should be adopted in the fiscal field. A federal mechanism involving the Union and the Member States is needed to establish what resources should be allocated to the federal level, and consequently the resources that remain available to the Member States' regional and local budgets. Because the taxpayer is unique, competences are by definition concurrent in this field, and the decision on the distribution of resources cannot be attributed exclusively either to the Union – which in this case would enjoy a predominant power over the other levels of government – or to the Member States – as is presently the case, preventing the Union's ability to manage economic policy effectively. The decision must be taken jointly, with participation by the Union and the lower tiers of government. This typically happens in all federal systems, where the member states are represented in the Upper Chamber and can take part in decision-making with regard to the distribution of resources. In the meantime, recognition of the European Parliament's right to participate fully – in parallel with the Council – in decisions concerning fiscal matters is a fundamental pre-requisite for a full democracy. This is because the Parliament directly represents European citizens, whose preferences should be reflected either in expenditure decisions or in the definition of the resources needed to cover those expenditures.

If this institutional reform is approved, i.e. if Europe is able to undertake a federal reform, an important element of change will be economic policy at European level. This will be managed predominantly by the Member States through the co-ordination method, and co-ordination will be effective because the Council has adopted the majority rule and the Commission enjoys real executive powers. The size of the European budget will be in any case more restricted than those of existing Federations and considerably lower in relation to GDP than national budgets. The euro will be regulated at the European level, which has no competence regarding personal income distribution, thus ensuring that redistribution policy is implemented at the national level only if the necessary consensus on levying new taxes is guaranteed, since neither money creation nor fiscal deficit are permitted any longer. The necessary prerequisites for radical reform of the European economy will be laid down so that it guarantees financial stability as well as income and employment growth, and promote accomplishment of a model of sustainable development.

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