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Fiscal Policy Rules and the European Constitution

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The normative limits of EU fiscal policy

Two important points in the EU debate on institutional reform are the definition of the role to be assigned the budget and the rules relating to fiscal policy. Since Economic and Monetary Union and the introduction of the euro, they have become of extreme importance. On the one hand, the Treaty of European Union (Art. 105) establishes that "The primary objective of the ESCB [European System of Central Banks] 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." On the other, the Treaty (Article 99) also establishes that the "Member States shall regard their economic policies as a matter of common concern and shall coordinate them within the Council." The divergence between the objective of price stability and the other economic policy objectives is evident: while the European Central Bank is obliged to

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pursue stability and has the instruments to achieve that objective assigned it by the Maastricht Treaty; for the other objectives, in particular, income expansion and full employment, it can only coordinate the decisions taken at the national level.

Actually, Article 99 also defines the procedures that the Council can adopt to achieve coordination: on the recommendation of the Commission and after evaluation in the European Council: the Council can, by qualified majority, prepare "a draft for the broad guidelines of the economic policies of the Member States and of the Community". Once the guidelines have been adopted, the Council verifies their implementation through the multilateral surveillance mechanism which can conclude with a recommendation, adopted by qualified majority and sent to the member state that has not conformed to the guidelines. In order to make its recommendation more persuasive, the Council may decide to make it public.

It is clear that public recommendations have a "moral suasion" effect in that they impact on domestic policy. In fact, the Council recently refused to approve the recommendations against Germany and Portugal to reduce their debt proposed by the Commission because it considered them excessive. But it is equally clear that European economic policy plays only a marginal role in achieving growth and full employment.

The greatest concern of the drafters of the Treaty of Maastricht was to prevent member states from having divergent economic policies that could jeopardise the Union's monetary stability. In fact, in addition to introducing a "no bail-out" clause to prevent national or local public institutions from having direct access to European Central Bank credit, the Treaty explicitly states (Article 104) that "Member States shall avoid excessive government deficits". This provision was further strengthened by the Stability and Growth Pact.

It should also be recalled that while Article 95 calls for the Council to adopt "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" using the co-decision procedure set down in Article 251, the second paragraph of the same article states that "Paragraph 1 shall not apply to fiscal provisions", which require a unanimous decision. As concerns "harmonisation of legislation concerning turnover taxes, excise duties and other forms of indirect taxation", Article 93 establishes that the Council will deliberate unanimously after consulting with the European Parliament (and the Economic and Social Committee).

Then again, even in specific sectors of Community competence, whenever fiscal measures are involved, unanimity is required. For example, as concerns the environment, the measures for achieving the objectives set down in Article 174 have to be decided using the co-decision procedure. Yet, Article 175 explicitly states that the Council shall deliberate unanimously with regard to "provisions primarily of a fiscal nature". Well known is the effect that this had on the CO_2/energy tax, which was an important part of the Commission's strategy for combating the greenhouse effect and was never adopted because of a lack of unanimity in the Council.

Constraints on management of the Community budget

If these are the main limits on fiscal policy, the constraints on the use of the European budget as an instrument of economic policy are even more significant. Article 268 establishes that "The revenue and expenditure shown in the budget shall be in balance", thereby excluding any anti-cyclical use of budget instruments. The next provision (Art. 269) then sanctions that "Without prejudice to other revenue, the budget shall be financed wholly from own resources" and defines the procedure for establishing them: "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." Therefore, new resources must not only receive the unanimous consensus of the member states, but also pass through their extenuating national ratification procedures.

Another constraint on the use of the budget as an instrument of economic policy is its size. The EU's general budget for 2002 called for payment appropriations of 95.7 billion euros, equal to 1.03 percent of the Union's GDP – an all-time low, 4.6 billion euros below the 1.14 percent GDP ceiling set by the Multiannual Financial Perspectives. Of this total, 45.2 percent is earmarked for the common agricultural policy (CAP), 34.5 percent for structural and regional policies, 8.4 percent for external actions, 5.2 percent for administrative expenditures, 4.1 percent for technological research and development, and the remaining 2.6 percent for other policies (energy, environment, consumer protection, internal market, industry and trans-European networks). Two considerations can be made:

• the small size of the budget prevents it from being used effectively as an instrument of economic policy given that not even significant changes in the expenditure flows could affect an ongoing economic trend and that revenue variations cannot have a real anti-cyclical effect because of the scarce weight of own resources and their lack of flexibility with respect to the sometimes substantial variations in production;

• expenditures are aimed at ensuring the financing of common policies; with a considerable part of the budget absorbed by the CAP, the first policy to be developed at the community level, and redistribution going in favour of the more disadvantaged areas, in that 63 percent of structural funds are allocated to the underdeveloped regions (Objective 1), only marginal resources are left for new policies – the environment, R&D, industry, trans-European networks.

In any case, the current size of the budget does not allow for the significant growth of the second pillar needed to achieve the objectives set down in Article 2 of the Treaty of European Union: "to 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," should the Council so decide.

Other critical considerations concern the composition of revenues. As seen, the Treaty calls for the budget to be financed entirely by own resources. *De facto*, after the Berlin European Council (24/25 March 1999) decision that there should be greater proportionality between revenues and the level of GDP, the greatest source of budget revenue in 2002 was the so-called fourth resource (43.0 percent), that is the GDP quotas of the member states, while the share of value-added tax dropped to 38.2 percent, other traditional own resources accounted for 16.6 percent, and the remaining 2.1 percent was made up of various revenues and the surpluses of previous years. The principle that the budget should be financed entirely by own resources was not respected.

Coordination of fiscal policy

The limits on fiscal policy, already evident in the Treaty provisions, are further aggravated by the Stability and Growth Pact. The latter establishes that in all cases, even during a period of economic recession, the member states' debt must not exceed 3 percent of GDP. It also sets the medium-term objective of a balanced or surplus budget, putting further constraints on the member states' ability to pursue independent stabilisation policies, especially if a country has been hit by an external shock when already close to the debt level set down in the Pact.[1]

To overcome this obstacle, there is once again talk of setting up a European Unemployment Fund, as first suggested in the 1977 MacDougall

[1] A. Petretto, "Teoria della disciplina fiscale e Patto di stabilità e crescita", in Petretto, A. (ed.) *Economia pubblica e Unione Europea* (Bologna: il Mulino, 2002) pp. 13-47.

Report.[2] The idea is to set up a stabilising mechanism at the European level that would automatically transfer resources from the fund to a country suffering increased unemployment due to recession to help overcome the negative conjuncture. But the situation has changed considerably since the drafting of that report. Indeed, the Maastricht Treaty adopted a different solution based on the consideration that it was unrealistic to think of increasing the budget significantly in the political climate of the time.

The solution found was innovative in one respect, but also had one important shortcoming. In what may seem at first glance like an important deviation from the theoretical model of fiscal federalism, which assigns the central level of government the responsibility for stabilisation,[3] the model of fiscal policy coordination adopted in Maastricht tends to leave the responsibility for stabilisation policies prevalently up to the single member states and merely asserts the need for coordination of fiscal policies at the European level. It tries to avoid the risk of asynchrony in stabilisation policies, with one country implementing expansive policies and another recessive ones, and to guide national fiscal policies towards convergent objectives by means of the multilateral surveillance mechanisms, thereby strengthening the federalist nature of the management of economic policy. But the drawback is that coordination is carried out in the Council, which can only adopt recommendations and has no coercive means with which to oblige the member states to abide by them.

Furthermore, all decisions of a fiscal nature at the European level are subject to the principle of unanimity, which ensures neither democracy nor effective decision-making. In fact, with a confederal structure like the one still existing in the fiscal sector, in which each member state has veto power, there is *de facto* no European economic policy, only a sum of national policies that are unable to provide Europe with the development policy it needs. Thus, monetary union is not accompanied by an effective economic union able to provide for income and employment growth and to help achieve the other economic policy and social objectives set down in Article 2 of the Treaty.

Stabilisation of the European economy

Once the need for a stabilisation policy has been acknowledged, two distinct problems have to be addressed. The first is achieving a macroeconomic equilibrium at the Community level through an efficacious

[2] European Commission, *Report of the Study Group on the Role of Public Finance in European Integration (MacDougall Report)*, Brussels, 1977.

[3] W. Oates, *Fiscal Federalism* (New York: Harcourt, Brace, Jovanovich, 1972).

mix of fiscal and monetary policies; in the EMU, monetary policy is now managed directly at the European level. The second is stabilising macroeconomic variables in the member states after they renounce the exchange rate instrument upon entering monetary union.

Fiscal policy guidelines are particularly important for stabilising the European economy, considering that the European Central Bank's statutes clearly establish that the priority task of monetary policy is to ensure price stability. The problem then is whether the stabilisation objectives should be pursued through changes in the community budget or through coordination of the fiscal policies managed by the member states.

In all existing federations, macroeconomic stabilisation of the entire economic system is the task of the central level of government. From a theoretical point of view, the main justification for this is the existence of externalities. In an open economy, a large part of public spending benefits non-residents through import variations, while residents have to bear the costs through the future taxes needed to finance the increased public debt. As always occurs when externalities are not internalised, governments in small open economies are likely to feel incapable of undertaking as much stabilisation as would be optimal: the more the benefits of the 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.

Thus there is broad convergence among economists that stabilisation policy must be attributed to the central level of government.[4] At the same time, this is also the line followed by the MacDougall Report which stated,

> 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 coordination 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

[4] First put forward by R. A. Musgrave in *The Theory of Public Finance* (New York: McGraw-Hill, 1959).

how to achieve adequate scale of operation.[5]

The first obstacle to the Commission taking direct responsibility for management of stabilisation policy described in the MacDougall Report seems to have been overcome by EMU in that monetary policy has become a European responsibility. But the second obstacle to active use of fiscal policy for stabilisation purposes still remains. What distinguishes the Community from existing federal states is the preponderant share of the total of public spending managed by member states' budgets as compared to what is managed by the Community budget: in 2002, 1.03 percent of European GDP. The MacDougall Report already stated 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 percent".

In general, it is felt that, given the current size of the budget and the strict rules governing it (no deficit, no flexibility because of the multiannual planning provided for by the 1988 budget accords), the Commission's role in managing stabilisation policy at the European level is limited to promoting coordination of the member states' fiscal policies.

Coordination is certainly necessary, even in the case of direct fiscal action by the central level of government, to prevent effects that are perverse with respect to the objective of stabilisation from developing as a result of pro-cyclical behaviours in budget policies at lower levels. But in the EMU, coordination is the only instrument available for dealing with symmetrical shocks that affect the entire economic community. Therefore, first of all, an assessment should be made of whether or not the Stability Pact's dictates of a balanced or close to balanced budget are effective in this context. In fact, at the member state level, given that the monetary policy instrument cannot be used, anti-cyclical variations in the budget balance, with surpluses during periods of expansion and deficits during periods of recession, tend to increase if all responsibility for stabilisation policy rests on the shoulders of the member states. Secondly, it should be recalled that as external effects increase with the completion of the single market, the member states' ability to develop stabilisation policies will decrease. Finally, and most importantly, it takes such a long time before the effects of a discretionary policy based on coordination of the member states' fiscal measures become manifest that it really has no stabilising

[5] EU Commission, Report of the Study Group on the Role of Public Finance in European Integration, Brussels, 1977.

potential at all.

The coordination of fiscal policies managed by the member states is, therefore, a necessary but not sufficient condition for ensuring the effectiveness of a community stabilisation policy in the face of symmetrical shocks hitting the entire European economic community in a macroeconomically significant way. Suffice it to recall that the effects of fiscal policies were asymmetrical in the European Monetary System, producing a deflationary bias. If the need for restrictive fiscal policies were to arise, for example to limit inflationary effects caused by an external shock on input costs, the risk would be that each member state would increase taxes and reduce expenditures without considering the deflationary effects induced by the other countries doing the same. The risk of "overshooting" arises from wanting to achieve a certain objective at all costs, regardless of the behaviour of the other partners. In the case of negative external shocks related to demand, resulting for instance from restrictive policies in the United States or Japan, it is more difficult to pursue expansive policies because some of the benefits of the fiscal policy are lost in any case because of spillovers and because countries are afraid of playing the role of "locomotive" providing benefits for "free-riding" partners.

Thus, coordination can undoubtedly reduce the probability of a deflationary bias in the management of fiscal policies by EMU member states, but because the political decisions needed to implement it take so long, overshooting remains a risk due both to automatic stabilisation effects and discretionary fiscal policy measures. It should also be underlined however that, in trying to reach an effective political decision, the larger states are likely to have a greater say in defining the coordinated fiscal policy measures – as occurs in all confederal political structures – and this could result in the economically and politically weaker states being less enthusiastic about any course decided upon.

Finally, the conclusion that can be drawn from these observations is that EMU, in a political framework that is destined to develop in a federal direction, must be put in a position to promote an autonomous stabilisation policy by means of adequate reform of budget policy. This calls for: a) an increase in the size of the budget, which is inevitable in any case for reasons of allocation; b) a change in budget rules making them compatible with the monetary stability objective but at the same time allowing for greater flexibility in the use of resources; c) the introduction of budget financing instruments that have elements of automatic flexibility on the revenue side as well.

One condition, however, is essential for implementing these reforms: strengthening the responsibility of the budget authority made up of the European Parliament and the Council of Ministers, by granting it the power to decide on community public spending. In fact, while in the current situation of a confederal political structure, containment of community public spending is ensured by rigid rules regulating the budget and decisions concerning revenues require the unanimous consensus of the member states, in a more federal kind of political union – which, it is hoped, will emerge from the work of the Convention on the Future of Europe – the entire budget policy, as concerns both revenues and spending, should be democratically controlled by joint decision-making of the two branches of the budget authority in accordance with the provisions set down in the Treaty limiting fiscal policy in the framework of EMU.

Asymmetrical shocks and a European Stabilisation Fund

In a monetary union, stabilisation mechanisms should be linked to the federal budget and should be such as to compensate both a general external shock affecting the entire Union and country-specific shocks with asymmetrical effects on different countries. If one adopts this perspective, largely prevalent in the literature on stabilisation policy, the idea of setting up an insurance mechanism against asymmetrical shocks seems reasonable. A mechanism inside the community budget that provides member countries affected by shocks with additional resources would compensate the negative effects that appear endogenously on the budget balance, making it possible to respect the rules for financial equilibrium laid down in the Stability Pact and to relaunch the economy affected by the slowdown.

A Report prepared for the European Commission in 1993 put forward the idea of a Stabilisation Fund.[6] Activation of the fund would be automatic and would not call for a discretional assessment, in order to prevent the transfers from having pro-cyclical effects: if they are allocated late, they only start to have an expansive effect on demand when the period of recession is already over. Financial support would be unconditional and not in the form of a repayable loan to make sure that the beneficiary is not burdened with repayment during recovery.

The Stabilisation Fund would have its own specific financing in the form of an *ad hoc* reserve in the community budget. The conditions under which the transfer takes place would have to be defined. The Report proposes that a country is deemed to have been struck by an asymmetrical shock when there is a positive deviation between the variation in the member country's unemployment rate and the EU average variation. Use of this indicator has

[6] European Commission, "Stable Money, Sound Finances. Community Public Finance in the Perspective of Emu", *European Economy*, no. 53, 1993.

the advantage that unemployment data are generally available after only a few months and are relatively harmonised throughout Europe. Other parameters could be chosen as long as they are standardised at the European level and generally published quickly.

In any case, the mechanism would transfer the sum of 1 percent of the affected country's GDP for every percentage point increase in unemployment rate greater than the European average. Nevertheless, to limit the amount of transfers and, therefore, the overall size of the fund, there would be a transfer ceiling of 2 percent of the GDP of the country in question. Consequently, transfers could grow up to a 2 percent maximum deviation of the country's unemployment rate from the European average.

Since the cost for the community budget of activating a mechanism like this, able to ensure the same degree of stability as the United States achieves through the automatic flexibility of its federal budget,[7] has been estimated at no more than 0.2 percent of GDP,[8] it should be feasible. Simple to activate, it would not suffer the usual problems afflicting stabilisation mechanisms: shock identification, delays in activation, pro-cyclical effects. Nor would the intergovernmental transfers – even if activated on the basis of the unemployment rate – have the disincentive effect on individual job seeking that is characteristic of unemployment insurance mechanisms.

How to finance the community budget

The MacDougall Report already emphasised the need to increase the size of the community budget to at least 2-2.5 percent of EU GDP in the pre-federal phase. A budget of this size "could reduce inequalities in living standards between member states by about 10 percent, compared with the average of about 40 percent in the countries studied, and might be judged an acceptable start". A larger budget (equal to 5-7 percent of GDP) "could provide sufficient geographical equalisation of productivity, living standards and cushioning of temporary fluctuations to support a monetary union". In the current political situation, the maximum target would seem to be a doubling of the size of the budget, in order to achieve more or less what MacDougall hoped for in the pre-federal phase. Then again, similar

[7] J. Pisani-Ferry, A. Italianer, and R. Lescure, "Stabilization Properties of Budgetary Systems: A Simulation Analysis", European Economy, Reports and Studies, no. 5 (Brussels: European Commission, 1993) pp. 511-38.

[8] A. Italianer, M. Vanheukelen, "Proposals for Community Stabilization Mechanisms: Some Historical Applications", European Economy, Reports and Studies, no. 5 (Brussels: European Commission, 1993) pp. 493-510.

conclusions were also reached by the 1993 report mentioned earlier. Thus the problem is to analyse the different ways in which the increase in community spending can be financed.

One option to evaluate is a new European surtax levied on top of the income taxes collected by the member states.[9] Involving a simple equalisation mechanism, such a community surtax would call for reform of the fourth resource, but it would also significantly increase its redistributive and, to some extent, stabilising effects. The total revenue produced by it – defined, as in the case of the fourth resource, as the residual difference between community spending and the revenue of other own resources – would be distributed among member states on the basis of each state's GDP share of total community GDP. Therefore, the total that each member state has to contribute to the community budget is modified by a progressive coefficient calculated on the basis of the ratio between the country's per capita income and the average per capita income of the entire Community. In this way, the richer countries will have to contribute more to the community budget than the economically less developed countries. Finally, each member state will have to impose the surtax on its citizens according to its income tax rules.

To make the financing of the community budget more transparent, once the overall amount that a specific country has to contribute to the community budget has been defined, the burden could be distributed among the citizens by imposing a surtax on the revenue of the national income tax.[10] Naturally, this would not change the nature of the progressive tax function adopted in each country nor the degree of progressiveness defined on the basis of the corresponding social welfare function.

Fiscal federalism and the theoretical justifications for the surtax

In the literature, the model of fiscal federalism normally referred to is the one originally worked out by Musgrave[11] and further developed by Oates.[12]

[9] A. Majocchi, "Dal Rapporto MacDougall all'Uem : il ruolo della politica fiscale", in Gerelli, E.and A. Majocchi, *Unione economica e monetaria europea: politica fiscale e vincolo di bilancio* (Milan: Franco Angeli, 1993) pp. 15-49; A. Majocchi, A. M. El-Agraa, "Devising a Proper Fiscal Stance for the European Community", *Rivista di diritto finanziario e scienza delle finanze*, vol. XLII,no. 3, 1983, pp. 377-400.

[10] A. Majocchi, "Le fédéralisme fiscal et la fonction rédistributive: le cas de la Communauté Européenne", *Revue française de finances publiques*, no. 20, 1987, pp.137-55.

[11] Musgrave, *The Theory of Public Finance*.

[12] Oates, *Fiscal Federalism*.

In this model, the redistribution function has to be centralised in that the movement of persons – all the greater the smaller the territory – can jeopardise redistributive policies carried out at the local level. In fact, poorer taxpayers will concentrate in areas in which incisive redistribution measures are adopted, with subsidies in favour of the lower income categories and high taxation on the higher ones, while richer taxpayers will establish residence in areas where redistribution policies are more moderate. Consequently, in those areas in which a strongly redistributive policy is planned, financial resources will diminish in that spending is high and the tax base low, while in the other areas the budget will generally be in surplus because the tax base has expanded.

This theory is contradicted by the current distribution of functions in the European Union,[13] in that the redistribution policy is and presumably will be for the foreseeable future taken care of at the national and not at the Union level. In the literature, starting with the famous essay by M. V. Pauly[14] on redistribution as a local public good, there have been theoretical justifications for this choice, which appear to be determined in Europe by the strong differences that remain at the national level in the preference functions relative to the optimal level of redistribution. Pauly's analysis was subsequently developed by R. V. Tresch,[15] who attributes the task of income redistribution among the various regional areas to the central level of government, while the lower levels remain responsible for inter-personal redistribution.[16]

Tresch's model assumes that for lower level governments, welfare depends only on the utilities of the individuals who live in the area, excluding any kind of interdependence of welfare functions among the various localities. In the same way, it is assumed that the utilities of the individuals depend only on the goods they consume and that there are no externalities. The welfare of the central government, on the other hand, depends only on the welfare of the lower levels of government, evaluated according to the welfare functions adopted by them which in turn depend on the utilities of the individuals. The constraint on the behaviour of the central government to respect the welfare functions of the local authorities

[13] G. Tabellini, The Assignment of Tasks in an Evolving European Union, CEPS Policy Brief, no. 10 (Brussels: Centre for European Policy Studies, 2002) <www.ceps.be/Pubs/2002/No10 Evolving-EU.pdf >.

[14] M. V. Pauly, "Income Redistribution as a Local Public Good", Journal of Public Economics, vol. 2, no. 1, 1973, pp. 35-58.

[15] R. W. Tresch, Public Finance: A Normative Approach (Plano: Business Publications Inc.,1981).

[16] Ibid; A. Petretto, Manuale di economia pubblica (Bologna: il Mulino, 1987).

and the assumption of no interdependence and no externalities radically changes the attribution of the redistributive function with respect to the traditional model: only the lower levels of government redistribute income to individuals according to their preferences, while central government uses lump sum transfers to equalise the different localities.[17]

This model seems to provide adequate theoretical justification for the proposal to finance the community budget with a surtax on the personal income tax collected by each EU member state: a progressively structured community levy based on the level of national income of the member states would correspond to a redistribution carried out by the central government, while a surtax on income tax, which divides the burden according to the progressive structure established in each country would correspond to a redistribution carried out by local authorities according to their preferences envisaged in the Tresch model.[18]

The advantages of this proposal can be summarised in three points:

- *transparency of the levy*: the citizens are aware of the fiscal burden linked to the financing of community spending. This becomes important if the size of the budget is destined to grow significantly;
- *redistributive effects*: this type of levy has positive redistributive effects among the various areas of the Community characterised by different levels of economic development. As such, it could be a first step towards an effective system of *Finanzausgleich*, which is inevitable if the Community moves toward a more federal structure;
- *stabilisation effects*: a levy related to income strengthens the budget's characteristics of automatic stabilisation. Naturally, the degree of stabilisation depends largely on the size of the overall yield as well as on certain technical characteristics of the levy that tend to reduce the time lag between the variations in income and variation in taxes. Finally, another advantage is that the proposal does not call for the preventive harmonisation of legislation relative to personal income tax.

Prospects for the European budget

The real problem is the political will needed to promote a very small increase (0.2 percent) in the size of the community budget to finance a Stabilisation Fund. Such a fund would ensure each member country against

17 Tresch, *Public Finance: A Normative Approach*; L. Rimini, "La funzione redistributiva in uno stato federale e il finanziamento della Comunità", in Gerelli and Majocchi, *Unione economica e monetaria europea*, pp. 143-72.

18 Rimini, "La funzione redistributiva in stato federale".

the risks of recession generated by an asymmetrical shock, avoid an increase in deficit linked to a fall in income, which automatically causes a reduction in revenues and an increase in public spending and, above all, would be a consistent move, after the introduction of the single currency, towards completion of Economic and Monetary Union and effective governance of the European economy.

Although the Commission's Agenda 2000 did not foresee the need for a larger community budget – not even in view of enlargement – new resources will inevitably have to be made available to the Union, not only to ensure the activation of a Stabilisation Fund, but also to strengthen the new policies required to achieve the Union's strategic objective for the next decade set at the Lisbon European Council in 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, the project described in the Delors White Paper[19] should be taken up again. It called for a new growth model able to reabsorb the under-use of manpower and the over-use of natural resources by means of a fiscal reform based on higher environmental taxes, on the one hand, and a reduction in social contributions (maintaining the overall fiscal burden constant) to favour employment, on the other. These structural measures should be accompanied by an increase in European public spending to build the infrastructure, especially the trans-European networks, needed for efficacious completion of the single market.

In addition to the new fiscal resources required to implement the Delors Plan, even greater resources are essential for full realisation of the second pillar, above all if certain positive decisions are taken concerning European defence, a *sine qua non* for an effective European foreign policy. There seems to broad consensus on this issue, also following the most recent events in the Balkans and the Middle East.

Fiscal policy rules in the new European Constitution

The problem of fiscal policy rules have been addressed by the Convention on the Future of Europe, set up by the Laeken European Council to plot a course of reform able to make European institutions more democratic and more effective. The basic problem is simple. The prerequisite for use of the

[19] European Commission, *Growth, Competitiveness, Employment. The Challenger and Ways Forward into the 21st Century*, White Paper, Brussels, 1993.

budget for allocative purposes (new policies for the environment, R&D or European defence) and stabilisation (a European Stabilisation Fund and an adequate structure for own resources) is that the new Constitution ensure effective economic governance and, therefore, recognition of the Union's role as a federal state. The Commission will have to have real executive powers and the Council will have to act as a Chamber of States in which, like in real federal states, the vote of the majority rather than unanimity rules in all fields, including fiscal matters. But such a goal still seems far away.

In particular, the federal mechanism will have to be used to define the fiscal resources to be attributed to the European level and, in parallel, the resources that will remain available at the state, regional and local levels. In this field, since there is only one taxpayer, competencies will – by definition – be shared. Consequently, decisions concerning the distribution of resources cannot be attributed exclusively to the highest level of government; they will have to be taken with the participation of the lower levels. This can only take place in a federal system in which the member states are represented in a second chamber. At the same time, recognition of the EP's right to concur in decision-making in fiscal matters on an equal footing with the Council, transformed into a Chamber of the States, is a fundamental point in that, in a representative democracy, the body directly representing the will of the citizens has to have a say in decisions not only on spending, but also on revenues.

If this institutional transformation is achieved, that is, if Europe is able to undertake a federal-type institutional reform, the result could be important novelties in the management of economic policy at the European level. It would mean management mainly by the member states but coordinated management, and coordination would be effective because the Council would vote by majority and the Commission would have real executive powers. The size of the European budget would still be small compared to other federal states and much smaller, in terms of share of GDP, than national budgets. The European level of government would manage the currency but not the interpersonal income redistribution policy, thereby ensuring that redistribution policies at the national level are pursued only to the extent that there is a consensus on bringing in more fiscal revenues, since states can no longer fall back on either budget deficits or money creation. This would lay the foundations for a radical reform of the European economy able to ensure both stability, and income and employment growth and to promote a new model of sustainable development.