Policy autonomy, coordination or harmonization in the persistently heterogeneous European Union?

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Authors: Luděk Kouba, Michal Mádr, Danuše Nerudová, Petr Rozmahel (MUAF)

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Reviewed by: Hubert Gabrisch (retired former Research Director and Head of Department of the Halle Institute for Economic Research (IWH))

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Policy autonomy, coordination or harmonization in the persistently heterogeneous European Union?

Luděk Kouba, Michal Mádr, Danuše Nerudová, Petr Rozmahel (MUAF)

Contribution to the Project

The goal of the paper is to examine and discuss the policy implications for the EU governance drawn from main findings of the MS77, MS78 and other related project contributions with a special attention given to lessons learned from integration of CEE countries into the EU and EMU.

Keywords:

EU integration, European economic policy, European governance, European Monetary Union, Full employment growth path, Good governance, Policy options

Jel codes:

E63, F15, F42

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Abstract

The European integration process is ongoing. Europe is still heterogeneous. Within this context, the paper addresses the question of whether policies in the EU should head towards autonomy, coordination or harmonization. Taking the path dependence effect into account, in the papers' opinion, Europe has gone too far in its integration process to be able to continue with policies fully under the competencies of individual member countries. Furthermore, the establishment of the common currency in the EU as a result of deep harmonization in the monetary policy area is an unambiguous precedent with many consequences. First of all, the habitual question still arises in the literature: does fiscal policy need to be harmonized to a comparable level, as these two policies necessarily complement each other? The paper argues that it does not.

First, the authors build on the theory of fiscal federalism, which often recommends the strengthening of the stabilization function of public finance; typically in the form of rules and surveillance institutions (e.g., Fiscal Compact, the Six-Pac, European Semester). And on the contrary, they usually refute the intensification of the redistribution function, due to the fact that intergovernmental transfers in contemporary Europe are highly unpopular. Second, Europe is still too heterogeneous and it will continue to be so in the future, simply because of the different cultures, mentalities, traditions, social relations and ways of thinking it harbours. In our context, this means that there are significantly different regimes of welfare states and extents of social policies among European countries, which strongly determine the character of public finance. And third, the tax systems across Europe are also highly divergent, with many different features of continued tax competition. Therefore, a top-down harmonization path towards a full fiscal union is neither politically enforceable, nor economically rational.

On the other hand, in order to keep the European integration process viable, it is necessary to reduce behaviour with features of moral hazard and free ride and strengthen joint responsibility for the fiscal development of public finances in the EU. In addition to the discussed matter of joint responsibility and fiscal discipline, the paper points out the open coordination method as an approach towards a sustainable alternative path between a fragmented Europe and a European super state.

1. Introduction

The European integration process is ongoing. Europe is still heterogeneous. These are the two initial truths discussed in this paper. Natural intuition says that these two statements are more contradictory than complementary. Therefore, the following question arises: should European countries head towards more autonomous or more unified policies? From the EU governance perspective, the paper examines whether a governance structure with central authority and centralized functions resulting from a harmonization process such as that of the European Monetary Union (EMU) is the best path towards further economic integration. Regarding fiscal policy, such a harmonization process would likely imply the formation of a fiscal union with centralized fiscal functions. Alternative scenarios can be either largely autonomous policies or a process of policy coordination leading to government structure with implemented co-ordination mechanisms.

Discussing these matters, and even critiques of the European integration process, should take the concept of path dependence into account. Path dependence, one of the most widely used concepts in contemporary social science (Rixen, Viola, 2009), explains how the decisions faced for any given circumstance are limited by the decisions made in the past, even though past circumstances may no longer be relevant. The best-known example of the path dependence effect is the QWERTY layout for typewriters. According to a seminal paper by David (1985), different keyboard layouts in modern computer keyboards would allow faster typing; nevertheless, the QWERTY layout prevails. And because of returns of scale, the layout seems to be unchangeable. North (1990), the proponent of new institutional economics, made a famous parallel between the original field of technology and the area of economic institutions. Later, Pierson (2004) imported the concept of path dependence into political science. Increasing returns are typical for political institutions since they significantly affect actors' expectations and, therefore, decrease the transaction costs associated with coordinating behaviour. In addition to this, the establishment process of institutions is usually related to high costs; institutions create incentives for maintenance, have learning effects, etc., and the system therefore evolves along a particular path that has been "locked in" (Arthur, 1989).

In the paper's opinion, the European integration process is a characteristic example of an institutional "lock-in", which makes an essential reverse almost impossible or highly unlikely. Moreover, this generally "locked-in" integration process is further embodied into vast monetary unification, where the costs of the potential failure of the EMU would be astronomically high. Until now, around 270 billion € have been paid by the European Financial Stability Facility, the European Central Bank and the International Monetary Fund to Greece (Financial Times, 2015). By way of comparison, this is twice the size of the EU budget. If Greece stopped to pay off its debts, potential losses for main creditors among European countries would be) 56 billion € for Germany, 42 billion € for France, 37 billion € for Italy and 25 billion € for Spain (Business Insider, 2015. Leaving aside the extent of financial help to the other affected Eurozone countries, it is apparent that European politicians have been determined to save the Eurozone under (almost) any circumstances. This confirms that path dependence plays a role in European policies. Therefore, the paper does not consider a return to fully autonomous economic policies to be realistic.

However, what does the truth about the continued heterogeneity of Europe bring to the discussion on whether EU policies should move towards autonomy, coordination or harmonization? Is the often-proposed concept of the harmonization of European economic policies really rational? Moreover, what is the lesson to be learned from the inclusion of Central and Eastern European countries?

The purpose of this paper is to discuss these questions while focusing on the area of fiscal policy. And since this is the final paper in the WWWforEurope Work Package 403, it has a more summarizing and

discursive character than the previous research papers. Furthermore, due to the final phase of the project as a whole, there are also links to other project papers, which have been discussed in the project meetings and will be more closely described in the final deliverables of the project; to be concrete, WWWforEurope Working Papers No. 1 Micossi (2012), No. 16 Schweickert, et al. (2013), No. 32 Thillaye (2013), No. 44 Aiginger, et al. (2013), No. 46 Van Arle (2013), No. 62 Rozmahel, Grochova and Litzman (2014) and Policy Paper No. 1 Aiginger (2013) and No. 15 Gabrisch and Staehr (2014). Additionally, this paper bases its discussion on heterogeneity, in particular, on the results of WWWforEurope Working Paper No. 9 Rozmahel, Kouba, Grochova and Najman (2013). Here, the paper (2013) found rather considerable convergence in terms of the many economic indicators, while none, or very slow convergence, with respect to most of the institutional indicators. As regards the impact of the CEE countries, heterogeneity increases when the core of the EU/EMU is enlarged through CEE countries, and in almost all areas. This implies that in contemporary Europe there are still many differences, logical and inevitable, in the paper's opinion, among particular countries – regarding their economies and political institutions, but particularly regarding their culture, traditions, mentalities, etc. This paper builds on the final thesis of WP No. 9 Rozmahel, et al. (2013): *"Instead of harmonization, we call for better coordination and joint responsibility in the fiscal area, and more generally in terms of policies and institutions in the European Union."* This statement implies that we distinguish between the coordination of fewer or more autonomous national policies on the one hand and comprehensive harmonization towards unified EU policies on the other.

Naturally, the establishment of the common currency in the EU as a result of deep harmonization in the monetary policy area is an unambiguous precedent with many consequences. First of all, the habitual question still arises in the literature. Does fiscal policy need to be harmonized to a comparable level, as these two policies necessarily complement each other? On the one hand, there are voices for creating a fiscal union as an inevitable complement to the common monetary union. The wide European debate on the pros and cons of a fiscal union, as well as a political and banking union, in relation with the sustainability of the monetary union, is presented by Allen, Carletti and Gray (2013). Also Beetsma and Giuliodori (2010) and WWWforEurope WP No. 46 van Aarle (2013) discuss selected aspects of various fiscal integration strategies in the EU. On the other hand, as stated by, for instance, De Grauwe (2012) or Burda-Wyplosz (2012), there are strong arguments for keeping a certain level of fiscal autonomy on national levels if there is no political will to pursue any stabilisation system of fiscal transfers on the supra-national level of the EU. The way of fiscal federalism, allowing inter-national or inter-regional fiscal transfers or autonomous fiscal policy, belongs among the adjustment mechanisms, in the case of asymmetric shocks' occurrence, that follow from traditional as well as "New" optimum currency areas theory (Mongelli, 2002). The arguments from the theory of fiscal federalism are more deeply discussed in part 3. In addition, the other arguments for coordination instead of harmonization in the fiscal area are highly heterogeneous national tax systems and also significantly different regimes and extents of welfare states among European countries.

The paper's understanding of the key terms, such as harmonization, coordination and autonomy, is elaborated in part 2. Part 3 supports the authors' line of reasoning against deep harmonization and the centralization of fiscal policy in the EU by arguments from the theory of fiscal federalism. The main part 4, "Coordination vs. harmonization within the context of fiscal policy integration in Europe", reminds of the persistent heterogeneity level in the EU, including the impact of the integration of CEE countries. It further discusses the potential pros and cons of autonomy, coordination and harmonization tendencies in European fiscal and tax policies. Part 5 summarizes the main ideas and provides some policy-relevant conclusions.

2. Coordination and harmonization: complementary or diverse concepts?

Generally, one can distinguish between autonomous policies, which can be accompanied (but not necessarily) by direct competition among individual countries, on the one hand, and full unification, which in certain areas is called harmonization, on the other. Nonetheless, because of the achieved level of integration in Europe, the paper labels rigorously autonomous policies at a national level as highly unlikely. Therefore, one should ask about the relationship between the terms coordination and harmonization. Analysing current literature, we can identify two views of the relation between harmonization and the coordination of particular policies.

The first view understands both terms to be close contemporary processes or directly as synonyms – that is, as opposites to the principles of subsidiarity, autonomy policies and competition among countries, e.g., in the tax area. This kind of argumentation for coordination-harmonization in the EU (EMU) is stated, e.g., in Clement-Wilz (2014), Gabrisch (2011), Giurescu and Vasilescu (2006), Köhler-Töglhofer (2011), Mortensen (2013), Roman and Bilan (2008).

Starting with the papers dealing with coordination of economic policies in a broader context, Roman and Bilan (2008, p. 509) emphasize the importance of broad coordination for successful development in the EU: "*Realizing an efficient coordination of economic policies represents a necessary condition for achieving a stable and durable economic growth within the Union and it implies increasing the credibility of the authorities, transparency of the economic policies and, last but not least, increasing cooperation (dialogue) between authorities*." Giurescu and Vasilescu (2006) consider the insufficient coordination of the economic policies to be a macroeconomic risk factor for European integration. According to them, the risk factor *"consists in the heterogeneity of member states' economies, the taxation strategies and the insufficient coordination between the budget policies and the monetary policy*." Gabrisch (2011, p. 69), who derives the necessity for coordination from current account imbalances, speaks also about the macroeconomic coordination, which *"needs a clear identification of union-wide employment goals, and the establishment of a high level institution (High Representative for Economic Policy) responsible for coordination following these objectives*." According to Clement-Wilz (2014, p. 99), current anti-crisis measures in the EU strengthen (and coordinate) fiscal discipline and the coordination of other economic policies as well. Moreover, he adds two preconditions for effective coordination in the EU (EMU): "*the first is based on flexible multilateral surveillance between States overseen by the Council, and the second based on a more rigid supervision on the part of the Commission*."

While the previous contributions deal with the coordination of economic policies in general, other authors, within the discussion on policy coordination, are more specifically talking about labour market policy (Rantala, 2003; Stockhammer, 2008), environmental policy Straume (2003) or harmonization of criminal law (Calderoni, 2010).

Regarding the term harmonization itself, it is most frequently used in the areas of tax policy and accounting. Furthermore, harmonization is typically discussed as the opposite of tax competition. While Benassy-Quere, Tranov and Wolff (2014), Fernandez de Cordoba and Torres (2012), Garcia, Pabsdorf and Mihi-Ramirez (2013) and Gullo (2013) argue for tax harmonization, Oates (2001) and Schäfer (2006) support the principle of tax subsidiarity. In the paper's opinion, in present-day Europe, tax competition still prevails in comparison to tax harmonization. On the other hand, the introduction of united accounting standards (e.g., International Financial Reporting Standards – IFRS) is an example of the implementation of meaningful and successful harmonization. In this sense, Samuels and Piper

(1985, pp. 56-57) define the international harmonization of accounting as "*the attempt to bring together different systems. It is the process of blending and combining various practices into an orderly structure, which produces a synergistic result*". Nowadays, e.g., Kapic and Basic (2013) and Wang (2014) evaluate that IFRS improve the quality of financial statements and the comparability of the data published by enterprises, etc. For more details from the relevant area of tax policy and accounting, see part 4.2.

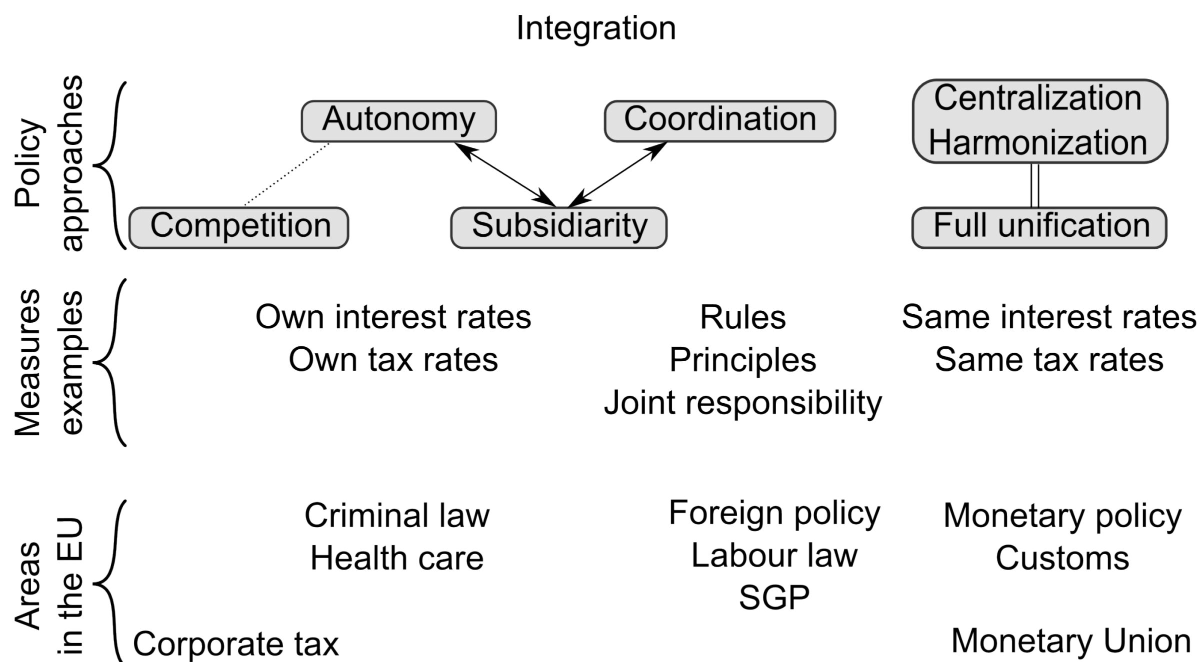
The second view, on the contrary, distinguishes coordination from harmonization. The differences are also discussed mainly by example of the tax area, for instance, Faria (1995), Genser and Haufler (1996), O'Shea (2007), Pirvu (2012) and Shikwati (2012). Faria (1995, p. 228) explain the difference in the following way: "*tax harmonization implies a high level of intergovernmental cooperation, that may materialize through regional economics agreements based on factors, that are common to the signatory states, while tax coordination includes measures through which the taxation system of a state adapts to the taxation system of another state, but respective measures will not lead to uniformity of taxes applied by public authorities*". Our understanding of the difference between coordination and harmonization is very close to Shikwati (2012) who, among others, points out the question of realism: *"we need to pursue "tax coordination" rather than "tax harmonization" as "harmonization" is mostly focused on achieving same tax rates, which is not realistic even in a common market. "Tax coordination" is focused on application of common rules and principles"*. While Shikwati's recommendations are focused on African integration processes (ECOWAS), O'Shea (2007, p. 814) comes to a similar conclusion when discussing the context of EU countries: "*the member states (EU) will continue to try to find solutions that meet their national interests and will comply with their EC Treaty obligations, but it is unlikely that such solutions will be found at the Community level*".

The distinctions between both concepts can also be demonstrated while using the example of law, namely environmental legislature. Faure (2000, p. 181) argues that harmonization "*is a term for the legal situation where either various separate procedures are approximated (harmonization of procedures) and separate legal acts remain in existence; or various substantive environmental laws are approximated; or the number of licences is reduced*", meanwhile, coordination: "*this term is reserved for the situation where separate environmental legal acts remain in existence with separate licensing requirements (and hence no harmonization of licences took place), but where the legislature has provided for legal rules which force the various authorities to take into account the separate procedures or licences*".

Finally, the theme of subsidiarity is another important point within the discussion on the future of EU policies, e.g. Bird and Ebel (2007), Eichel (2002), Gelauff, Grillo and Lejour (2008), Lighian (2012) and Sinn (1994). Schäfer (2006, p. 249) argues that "*The key vision should not be a Europe of harmonised equalness, but a Europe of subsidiarity, of plurality in differentiation*". From our point of view, the principle of subsidiarity lies somewhere between autonomy and coordination on the related scale (see Figure 1); in other words, it is compatible with both of these approaches to economic policies in integrating groupings.

The paper discusses, in particular, two approaches to the policies within an integration process: harmonization and coordination. Within this discussion, we apply the second mentioned view – a differentiation between the approach of coordination and harmonization. While coordination is a process maintaining certain levels of autonomy, harmonization tends to lead to a full unification or centralization of particular policies. The differences are summarised in the following figure.

Figure 1: The scale of the policy approaches in the integration groupings.



Source: Authors

3. Coordination vs. harmonization: reflections in the theory of fiscal federalism

The paper's approach, the differentiation between policy coordination and harmonization, can be more deeply supported through the use of arguments from the theory of fiscal federalism. Subsection 3.1 deals with the public finance role in the theory of fiscal federalism; subsection 3.2 focuses on the links between the theory of fiscal federalism and the current situation in the European Union.

3.1 Fiscal federalism and the perception of public finance functions

Within the context of the interventionist 1950s, Musgrave (1959) focused on the economic role of the public sector – his well-known triad of stabilisation, distribution and allocation – solely with single-level governance. Oates (1968, 1972) strived to apply Musgrave's typology of public finance roles in a multi-level governance model labelled fiscal federalism. Fiscal federalism seeks the best level of governance to perform public finance functions in an economy, i.e., provide public goods and collect budget revenues. Oates simplified it into a two-level public administration model: centre vs. regions, e.g., the German federal government vs. länders, the US federal government vs. federal states, or, in this paper's case, the EU vs. member states.

According to Oates, the stabilization function should be kept at a central level. Regions are usually not able to react efficiently to economic decline, e.g., regional government cannot perform currency devaluation. In addition to this, fiscal policy instruments only have a limited impact compared to their implementation at the central level, due to the openness of current economies. Increased expenditures by regional government will be attenuated by their partial outflow out of the region to foreign producers in the form of increased imports. Due to a worsening of the trade balance, regional

government will have to use other stabilisation instruments such as access to low-interest loans and tax exemptions for foreign investors. As Oates points out (1968, p. 44), such policies can be successful, but only within a particular region, not within the whole country (economic union): a result can be the relocation of investors from a neighbouring region within the same country (economic union).

Similarly, Oates also recommends centralisation in the case of the redistribution function, which is based on the assumption of mobile production factors. If the regional government in a prosperous region seeks to intensify a redistribution function through progressive taxation and vast social transfers, it is probable that people will start to migrate to a region without progressive taxes. In contrast, high social transfers will cause an inflow of low-income population groups (one can observe this in the current EU). These movements will undermine the efforts to redistribute income and increase the standard of living of lower income groups, as high-income groups leave the region and cannot be exploited as a source for social transfers. Moreover, high taxation of capital can result in the leaving of investors, which can further weaken the local economy. Given the fact that particular production factors can have diverse mobility at a regional and national level, various levels of government should use differing types of taxes (e.g., property tax or VAT at a regional level).

Finally, the allocation function should be, according to Oates, decentralised. The preferences of public service users are non-homogenous; therefore, public services can be demanded in various quantities and qualities across particular regions. It is assumed that lower levels of governance have a better understanding of people's preferences since these are in closer contact with their citizens and have a better knowledge of local conditions (conditions of roads, transportation, environment, etc.).

Oates' approach, therefore, meant a shift in the understanding of government roles. The contemporary literature usually distinguishes two evolutionary stages of fiscal federalism: first generation and second generation. There is not a strict boundary between them; however, the most characteristic difference of the second generation lies in its focus on the growth effects of fiscal decentralization instead of equity effects, which are typical for the first generation. For instance, Weingast (2009, p. 280) says that models belonging to the first generation of fiscal federalism stress the importance of intergovernmental transfers in order to balance regional disparities, whereas the models of the second generation emphasize the role of tax incentives. Regional and local governments are motivated to the efficient allocation of resources and provide market-enhancing public goods when they get a higher share of tax revenues. Furthermore, Weingast (2009, p. 279) remarks that while the first generation is a rather normative approach (what we should do), the second generation is a more positive approach (what we can do under given conditions). Considering contemporary EU policies, Tanzi (2008) points out two omitted aspects. First, he sees a need to anchor fiscal federalism theories in historic time (see the reference to North's concept of path dependence in the Introduction). Second, he emphasizes the fact that strong supranational institutions exist in the globalized world of the 21st century. Moreover, these global institutions also play a significant role in the area of public finance. Tanzi even concludes (2008:711): "there is need for theories that deal with the role and the form of "global governments".

3.2 Fiscal federalism and current EU policies

Before each application of the theory of fiscal federalism in the context of the EU, one has to take into account two specific features of the EU budget. First, the budget is exceptionally small; secondly, the structure of expenditures is extraordinarily specific. The size of the EU budget is only about 1 % of GDP (148.5 billion € in 2013). Regarding the structure of expenditures, 57 % of them are related to the

allocation function and about 40 % to the redistribution function, whereas only minor expenditure chapters represent macroeconomic stabilization.

The contrast between such a marginal role of joint fiscal policy and the centralised monetary policy represented by the European central bank is an important reason for a vast discussion regarding a reform of the EU budget. Furthermore, the financial, economic and public debt crisis intensified the discussion on the necessity of a strengthening role of EU fiscal policy.

Therefore, the paper will now take a look at the part of this discussion using arguments from the theory of fiscal federalism where, in fact, one can identify two lines of argument. A (minor) group of authors propose reforms aimed at a full fiscal union in the EU, while the majority of authors suggest only a partial strengthening of the role of the EU budget.

Regarding the first group, Bordo, Jonung and Markiewicz (2013) or Vallee (2014) are proponents of the approach supporting harmonization and centralization towards a full fiscal union. Bordo, Jonung and Markiewicz (2013, p. 482-483) identify five conditions for an efficient fiscal union, which can prevent risks of divergent fiscal policies: a credible commitment to a no-bailout rule, a degree of revenue and expenditure independence reflecting the preferences of the voters, a well-functioning European system of transfers in times of distress, the creation of a euro bond market serviced by taxes collected by the EU government, the ability to learn from and adapt to changing economic and political circumstances. The conclusions are based on the fiscal history of five federal states Argentina, Brazil, Canada, Germany, and the USA.

Regarding the second group, Bargain (2013), Begg (2009), Csürös (2013), Dabrowski (2013), Hinarejos (2013) or Molnar (2012) are proponents of the approach questioning both the sense and enforceability of a fiscal union in Europe. Similarly to this paper, Hinarejos (2013) distinguishes between two models of fiscal federalism: the “surveillance model” and the “classic fiscal federalism model”. Concerning the former, Member States continue to have full fiscal competence (tax revenues and allocation of sources) as well as the competence to conduct a general economic policy. The mainly corrective EU role is, in particular, to enforce fiscal discipline and prevent structural asymmetries and asymmetric shocks. On the contrary, the latter assumes a much deeper centralization in the form of an independent sphere of fiscal authority. Both the Member States and the EU have the competence to raise revenues and provide (different kinds of) public goods. This model typically also includes a version of a “transfer union”. Hinarejos considers the surveillance model to be a natural progression of the status quo in the EU.

Other authors, beyond Musgrave and Oates, explicitly discuss the distribution of fiscal functions in the EU. Csürös (2013) remarks that the EU strengthened the stabilisation function (outside the EU budget) and the allocation function (of the budget) during the crisis. Nevertheless, according to the fiscal federalism theory, the EU should further strengthen these tools of economic governance that are also relevant to tackling asymmetric shocks. In fact, Csürös claims the new financial framework (2014-2020) has brought a reduction in the redistribution function and more restrictive conditions for the subsidy system. While Csürös states that the EU has not extended the redistribution, Bargain (2013) directly argues against it. Introducing an EU tax and transfer system, the potential gains will not be big enough to generate sufficient political support for such a reform. Instead of that, he suggests exploring other ways to improve macroeconomic stability without redistribution of incomes. Similarly to Bargain, Begg (2009) points out political economy issues describing group interests and corruption risks during the transferring of resources between the Member States. Besides, Begg considers the current size of the EU budget too small to be able to fulfil the redistribution function in an operative way. In addition to this, Begg mentions an ambiguity about what things flowing from the EU budget to Member States

should be called distributive and what should be called allocative. Dabrowski (2013) admits that the current integration architecture of the EU/EMU contains several elements of fiscal union (bailout facilities, fiscal rules and their surveillance, harmonization of indirect taxes). On the other hand, he states that the establishment of a common currency, in general, has been followed by neither fiscal nor political integration. Furthermore, according to Dabrowski, neither does the OCA theory provide unquestionable arguments in favour of the necessity to complement monetary integration with the centralization of fiscal resources.

Summarizing the discussion on the EU budget, which uses arguments from the theory of fiscal federalism, most of the authors recommend strengthening the stabilization function of public finance, usually in the form of rules and surveillance institutions (e.g., Fiscal Compact, the Six-Pac, European Semester). On the contrary, they usually refuse an intensification of the redistribution function, as intergovernmental transfers in contemporary Europe are highly unpopular. A full fiscal union in contemporary Europe is, therefore, considered to be politically unenforceable.

4. Coordination vs. harmonization within the context of fiscal policy integration in Europe

Part 4 deals with the matter of fiscal policy integration in the current EU. Section 4.1 summarizes the reasons, features and consequences of persisting heterogeneity in the fiscal area in Europe, including the impact of the integration of CEE countries. Section 4.2 then provides a case study focusing on a key area of fiscal policy – the tax system.

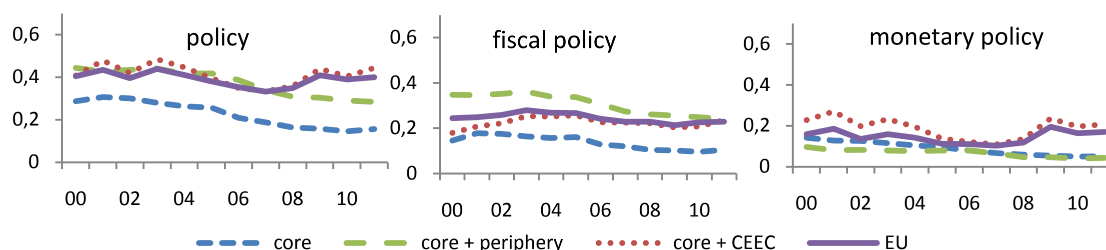
4.1 Fiscal policy heterogeneity in the EU

Fiscal policy has so far to a large extent been heterogeneous in Europe. The differences in fiscal policies were clearly revealed due to the global financial crisis and its aftermath. The crisis had a different impact on the particular EU states. Also, the fiscal policy reactions were dissimilar across EU countries. Whereas some of the countries, such as the Czech Republic, Latvia, Hungary, Spain and also Greece, attempted to slow down or prevent rising fiscal deficits by restrictive policies, other countries, including Austria, Germany, Denmark, Finland, Sweden and Poland, reacted by fiscal expansion. As stated by Kočenda, et al. (2008), the fiscal policies were largely heterogeneous without significant progress in convergence before the crises in Europe. Using some alternative measures, their paper observes poor progress in fiscal convergence and a lack of fiscal discipline in general across the EU states. Furthermore, the new EU countries are shown as relatively more fiscally disciplined than the EU15.

Regarding the current state of macroeconomic policy harmonization or coordination efforts in the EU, WWWforEurope WP no. 9 Rozmahel, et al. (2013) provide some evidence of the persisting fiscal policy diversity in the EU using the multi-dimensional cluster analysis approach. In addition, they show that the monetary policy measures of the non-Eurozone countries do not converge. In other words, the new EU states do not harmonize their monetary policy strategies and priorities to the common monetary policy conducted by the ECB. Using the average distance within clusters of the EU core, periphery and CEE countries as a measure of the internal homogeneity of the country-clusters, they examined whether the heterogeneity in the area of macroeconomic policy changes over time. Furthermore, they checked the change of heterogeneity when enlarging the core cluster by periphery,

CEE countries or both.to examine contributions of both country-groups to changing heterogeneity in analysed dimensions.

Figure 4: Average distances in clusters as a measure of internal homogeneity in 2000-2012



Source: Rozmahel, et al. (2013)

Two indicators of monetary and fiscal policy were included in the dimension. Then the dimension was split into monetary and fiscal parts. The Monetary Policy dimension examines the internal homogeneity of clusters applying Official Lending Rates (%) and the development of Money and Quasi Money (% of GDP). The dimension of fiscal policy was made using indicators of Total Government Expenditures (% of GDP) and Implicit Tax Rate on Labour. Both fiscal measures are under the deliberate control of the autonomous national governments of the EU countries, and at the same time, these measures are not explicitly determined by the Growth and Stability pact, nor by its actual modification in the form of the European Fiscal Compact, signed in 2012. Therefore, the inclusion of those indices aims at shedding some light on fiscal and tax policy harmonization processes in the EU. The level of internal harmonisation of the macroeconomic policy conduct in the EU core countries steadily rises, as indicated by the decreasing curve of the average internal distance within clusters. The convergence is also obvious when enlarging the core by CEE as well as peripheral countries until 2007. Since the crisis hit 2007/2008, the CEE countries have contributed to rising policy heterogeneity within the EU, as indicated by rising curves since that time. Clear convergence tendencies among the Euro area core countries are shown in the figure when splitting the indices between the fiscal and monetary dimension. The figure also indicates clear divergence of the CEE countries, since the heterogeneity of Euro area core country-cluster rises steadily when enlarged by CEECs. The peripheral countries proved slow progress in convergence towards the Euro area core countries over the analysed period of 2000-2012. Significantly diverse monetary reactions of CEE countries from the core of the Euro area during the crisis and its aftermath are shown in the figure describing the monetary policy dimension.

Considering the impacts of existing fiscal heterogeneity upon integration processes, there is still a lack of empirical literature, as noted for instance by Darvas et al. (2005) or Crespo-Cuaresma et al. (2011). Darvas, et al. (2005) provide evidence of a strong relation between fiscal convergence and more synchronised business cycles in their pioneering study. In addition, they also find that reduced primary deficits improve business cycle synchronisation across the OECD countries. Crespo-Cuaresma, et al. (2011) also point out the lack of attention to fiscal policy influence on business cycle similarity of the EU countries in contemporary literature. Applying measures of the fiscal budget surplus, trade integration measures as well as instruments, they analyse the effect of fiscal policy on cyclical synchronisation in the Euro area. Additionally using the instruments for fiscal policy measures capturing mainly the information on political determinants of fiscal stances, they find out that the fiscal deficits are identified as sources of idiosyncratic macroeconomic fluctuations in the Euro area. Their results support the central findings of the study by Artis, et al. (2008) which identify divergent fiscal

policies and heterogeneous labour market rigidities as factors reducing business cycle synchronicity. Further focusing on the role of CEE countries, WWWforEurope WP No. 62 Rozmahel, et al. (2014) examine the effect of the fiscal indiscipline and dissimilarity on business cycle correlation in the EU. They find a negative link between fiscal dissimilarity measured by differences in per capita national debts and business cycle correlation. Their analysis also provides some evidence of a negative effect of fiscal indiscipline and dissimilarity in the countries staying out of the Euro area. An increased effect on business cycle correlation has been observed since 2007, which the authors attribute to the influence of the global crisis. Holm-Hadulla, et al. (2012) identify a pro-cyclical fiscal behaviour of governments that have no strict numerical expenditure rules. Concluding that countries with strict numerical expenditure rules do not have a pro-cyclical bias of their spending policy, they provide arguments for the need for rule-based restrictions to expenditure policy.

The actual heterogeneity in the fiscal area together with the trends of rising deficits and debts in the EU represents a significant problem for the effective and sustainable functioning of the EU and also in achieving long-term strategic goals in the economic area. Deficits limit the functioning of discretionary fiscal policy as a tool of adjustment in case of asymmetric shock occurrence. The indebtedness is naturally costly for other EU member states that contribute to the bailouts. Fiscal heterogeneity negatively affects interest rate development and might be a potential source of idiosyncratic macroeconomic fluctuations in the Euro area. On the other hand, there are still arguments for why strong harmonisation, leading to fiscal unification in terms of unified tax systems and spending policies, might not be the right solution for Europe. Fiscal policy harmonisation in this sense implies the harmonisation of tax policies and also welfare states since they are highly interrelated. The following section examines the heterogeneity factors in the area of tax policies in the EU.

4.2 Tax systems and policy in the EU: harmonization, coordination and competition

The coordination of taxation systems has been discussed in the European Union since the very beginning of the integration efforts in the 1960s. Primarily, the intention was very ambitious – the aim was not tax coordination but full tax harmonization – i.e. not only structural harmonization, but also harmonization of the tax rates. The development of tax harmonization in the European Union was developed differently in the areas of indirect taxation and direct taxation.

The effort of tax harmonization in the area of indirect taxation had been, since the very beginning of European integration efforts, connected with the idea of the creation of an internal market. Its establishment consisted of the elimination of the obstacles of the market, mainly represented by the different indirect taxation systems and different tax rates. France represented the only Member State that applied a system of value added tax in the early 1960s. All the other Member States applied a cumulative cascade system of taxation, which in fact was not tax neutral[1]. This system of turnover tax led to market deformation, for the tax burden increased together with the length of production or the distribution chain[2]. All these circumstances led the European Commission to not only to harmonize the system of indirect taxation, but also replace the current cumulative cascade system of turnover tax with a system of value added taxation. This effort of structural harmonization was completed in 1967 by the adoption of Directive no. 67/227/EEC, which committed EU Member States to introduce the

[1] The number of production stages influenced the amount of the final tax, as it was levied on the gross amount of the production value (not just on value added as in case of value added tax).

[2] Ibid.

value added tax system by 1st January 1970. The second step – the harmonization of tax rates – proved to be extremely difficult, mainly due to the fact that tax rate harmonization is perceived by EU Member States as an infringement of their national sovereignty. Furthermore, it could be difficult due to the fact that tax rates represent the tools of fiscal policy and their harmonization does not leave any space for influencing aggregate supply and demand. Tax rate harmonization might also endanger the budget revenues in states where the value added tax creates a significant part of the tax mix. And, finally, there could be difficulties due to the unwillingness of the European Commission to legally enforce and ensure the implementation of the directives into the national taxation systems. Based on this, the European Commission reviewed its attitude towards tax rate harmonization in the area of indirect taxation and started to talk instead about tax approximation. The effort of tax rate approximation resulted in the adoption of Directive no. 92/77/EEC, setting the minimum tax rates at 15% in the case of a standard value added tax rate and 5% in the case of a reduced value added tax rate.

Structural harmonization in the area of direct taxation seemed to be less complicated in the beginning. All EU Members States, except Italy, applied corporate income tax and personal income tax separately. However, despite a similar structure, the specific rules and methods in the taxation systems differed significantly. Due to these findings, the European Commission aimed its attention at such direct taxes for which harmonization is essential in connection with the smooth functioning of the internal market. In the area of direct taxation, such a tax represents corporate income tax, for capital is considered a highly mobile factor, which can very easily move to a country with a more favourable taxation system. Therefore, the corporate taxation system affects the internal market very much. Similarly, as in the case of indirect tax harmonization, EU Members States perceived the harmonization efforts in the area of direct taxation rather as attempts to limit the fiscal sovereignty of Member States. Mainly that fact can be considered as the key issue why the European Commission did not reach greater success in this field during the 1970s and 1980s[3]. It is also connected with the fact that the European Commission has to enforce the provision in the form of a directive, the approval of which requires the unanimity of all EU Member States.

The last decade of the previous century brought waves of international mergers and acquisitions, electronic trading and an increase in the mobility of the factors. All these new phenomena had a significant impact on corporate taxation. The fact that the EU Member States were not able to reflect those changes into their national taxation system led to the creation of obstacles to the smooth functioning of the internal market. Based on this, the European Commission started to research the differences in effective corporate tax rates within the EU, different methods of tax base construction and its influence on the effective tax rates, and to identify provisions that can hamper cross-border activities of companies. Subsequent to this research[4], the European Commission suggested four possible models for corporate tax harmonization in the European Union – the Home State Taxation System, the Common Consolidated Corporate Tax Base, the European Union Company Tax and the Compulsory harmonized Corporate Tax Base. In the end, the European Commission decided to set the Common Consolidated Corporate Tax Base as its long-term model. After more than ten years of work, the Commission published the text of the CCCTB Directive proposal on 16th March 2011.

At present, the main goal of tax harmonization and tax coordination in the European Union is mainly aimed at the enabling free movement of people, capital, goods and services. It is also necessary to

[3] The Commission had to withdraw its proposal suggesting the minimum corporate tax rate between 45% and 55% in 1975. Consequently, in 1994 withdrawal of the proposal of a directive suggesting the minimum corporate tax rate at 30%.
[4] COM(2001) 582 final.

state that, in connection with the financial crisis and its aftermath, the European Union initiated a discussion on the possible taxation of the financial sector. This represents another area in which the European Union is considering tax harmonization vs. tax coordination. Based on the latest economic development, current taxation policy in the European Union is aimed mainly at the stabilization of the tax capacity of EU Member States, the smooth functioning of the internal market and the support of employment.

However, there is an on-going discussion as to whether to preserve tax competition (i.e. the situation where there are different taxation systems and different tax rates within the EU) or whether to try to reach tax harmonization.

Tax harmonization versus tax coordination

Pros and cons can be found. The need to preserve maximum fiscal autonomy should be considered the first factor against tax harmonization in the European Union. The role of national central banks is limited in connection with the monetary union, for their competencies have been shifted to the European Central Bank. Therefore, members of the Eurozone can only use fiscal tools (mainly representing the level of taxation and government expenditures) to influence the economic cycle. Therefore, it should be as autonomous as possible, so that member states would be able to deal with economic shocks[5]. From this point of view, tax harmonization is not desirable, for it limits fiscal policy, mainly with respect to budget revenues.

The fact that the different level of the tax rates set in the member states reflects different structures of taxation and specifics of individual member states represents another very important reason for the negative attitude towards tax harmonization. This fact is obvious mainly in the case of the states applying a higher level of value added tax rate (hereinafter referred to as VAT). In those states, collected VAT represents a substantial part of budget revenues. This is mainly the case of Denmark, Belgium or Spain. Those specifics could not be reflected if tax rates were harmonized. Moreover, the harmonization of tax rates in this type of member state would create significant pressure on the revenue side of the budgets.

As Hamaekers (1993) mentions, tax competition can result in a spontaneous harmonization effect in the form of a spontaneous approximation of the tax rates; therefore, there is no need for artificial harmonization. According to this paper, this effect may arise between two neighbouring countries in the case of VAT[6]. According to this paper's view, this effect is questionable. A different level of VAT tax rate has been applied in the European Union since the introduction of the common system of indirect taxation and no spontaneous harmonization effect in the European Union has accrued since that time. We believe that the above-mentioned effect has only a regional character[7] and, therefore, there is no pressure on the government to approximate the tax rates.

Furthermore, another argument that may refute the myth that the monetary union and common market need tax harmonization is the example of the United States. Even though they represent an area with a much higher degree of integration (mainly fiscal harmonization) than the European Union, the

[5] Through built-in stabilizers – progressive income taxes.

[6] The residents of one Member State can drive to a shop in a neighbouring country, applying a lower VAT rate, and due to this fact, the goods are cheaper for them. That circumstance may cause a spontaneous harmonization effect between two neighbouring countries.

[7] Or a cross-border effect – i.e. the goods (due to the lower tax rate) are cheaper for the residents of a neighbouring country only to certain distance from the border. The transportation costs to buy goods may in more distant places eliminate the difference between the prices.

taxation systems of members of the Union differs significantly. The existence of different taxation systems in the United States does not deform the market environment.

As Mitchell (2002) mentions, tax competition generates a responsible tax policy with a lower tax burden for business entities, which creates a positive environment of higher economic growth. Without tax competition, the government might behave like a monopoly structure. Analogically with a monopoly situation, when the prices are higher than under competition, in case of the tax harmonization, the tax rates are set at a higher level than under tax competition. Tax competition, therefore, leads to a decrease in tax rates, and not to an increase.

Capital mobility enables taxpayers to move the capital into a low tax jurisdiction. Due to this fact, tax competition can be also considered as a very important factor contributing to the liberalization of world economics, as it exerts pressure on the decrease in tax rates and a decrease in budget expenditures.

A lower level of taxation should not, necessarily, lead to a decrease in budget revenues; on the contrary, it can lead to an increase in tax bases. As a result, a decrease of the budget revenues and increase of the budget deficit need not necessarily occur.

The negative consequences of tax harmonization can be summarized as follows:

- tax harmonization leads to a higher level of tax rates[8]
- tax harmonization contributes to lower economic growth[9]
- tax harmonization does not prevent an oversized expansion of the public sector
- tax harmonization very significantly intervenes in the national sovereignty of EU member states
- tax harmonization can significantly endanger budget revenues
- tax harmonization is connected with the loss of the fiscal autonomy of EU member states

It is necessary to mention that there are also positive arguments for tax harmonization. First, even though competition is generally considered a factor increasing market efficiency, as it allows efficient source allocation, this is not the case with tax competition. As Kubatova (2012) mentions, in the case of market failure, the competition is not able to guarantee efficiency. In this case, we can talk about market failure, for the taxpayer does not receive an equivalent value against the paid tax and, therefore, it is not interesting for them to pay tax in the country in which they use public services. Therefore, tax competition leads to a restriction on the public sector. In extreme situations, it could lead to the elimination of taxation. Tax competition leads to an increase in the taxation of immobile factors (mainly work) and a decrease of taxation of highly mobile factors (mainly capital). It also leads to the inappropriate structure of budget expenditures, as the government provides incentives, subventions and support in order to attract capital.

Tax competition can lead to tax base erosion in other states and to a deformation of the effective allocation of capital and services, as Edwards and Rugy (2002) mention. Decreasing the tax rates may result in a relative increase in competitiveness, but it produces negative externalities for other states, mainly in the form of a decrease in budget revenues and economic growth.

Tax competition, in the field of corporate taxation, does not allow companies to act on the internal market to fully use the advantages that the internal market provides. Therefore, in this area, it is necessary to reach at least a certain degree of tax harmonization. In the case of structural harmonization in this area, there would not be any difference between nominal tax rates and effective tax rates. In this situation, there would not be any asymmetric information, as the information about the

[8] Without competition, the governments are setting higher tax rates.
[9] Higher tax rates decrease overall productivity and discourage foreign capital.

effective tax burden would be accessible not only for the multinational corporations, but also for small and medium sized companies.

Furthermore, tax competition may lead to the inefficient provision of public services, as mentioned by Zodrow (2003). The inefficiency lies mainly in the extent of redistribution programmes. In that connection, it is necessary to mention that tax competition in the public sector can prevent oversized expansion. In a situation where the ability to pay principle does not lead the economic subjects to pay taxes in the country where they use the public service, competition in the area of taxation is considered harmful.

The existence of externalities can be considered another argument for tax harmonization. A state, while creating its tax policy, does not take into account its influence on different countries. In reality, the taxation system influences the budget revenues of different countries. Bigger countries have the power to influence world prices and to improve their own exchange relations[10]. Another example of externality can be a situation where a state protects its domestic industry through taxation.

Generally, tax competition is considered beneficial, as it creates the pressure to decrease budget expenditures. From the point of view of the European Union, it could increase overall competitiveness. On the other hand, an unrestricted and undirected tax competition in the area of mobile factors can endanger the tax revenues of EU member states. It should be noted that current tax competition in the EU should not be perceived as a desired result, but rather as a result of the failure of the harmonization process.

The negative effects of tax competition can be summarized as follows:

- tax competition leads to a shift of the tax burden from capital on work
- tax competition leads to an inappropriate structure of government expenses
- tax competition leads to the ineffective provision of public services
- tax competition may lead to the impoverishment of a state
- tax competition can deform the flows of financial and real investments
- tax competition does not allow effective source allocation
- tax competition does not allow full use of the advantages connected with the internal market
- world prices can be influenced through tax competition

In a situation where the main aim of the tax policy in the European Union is the smooth functioning of the internal market and an increase of competitiveness, not only of the market subjects, but of the European Union itself, we can set these criteria, which should be fulfilled either by tax harmonization or by tax competition.

[10] The ratio of the export prices index and import prices index – i.e. “real” conditions under which the country exports and imports the products.

The evaluation of tax harmonization and tax competition is stated in the following table:

Table 1: Evaluation of tax harmonization and tax competition

Criterion	Tax harmonization	Tax competition
Fiscal autonomy	no	yes
Stability of budget revenues	no – tax rate does not reflect the specific of individual states	yes – but not in countries with capital outflow
Effectiveness of public expenditures	no	yes
Increase in the competitiveness of the market subjects	yes	no – leads to an increase in the compliance costs of taxation
Inappropriate structure of budget expenditures	no	yes
Excessive taxation of immobile factors	no	yes
Full usage of the advantages connected with the internal market	yes	no
Effective source allocation	yes	no
Existence of asymmetric information	no	yes
A difference in nominal and effective tax rate	no	yes
Tax rate	higher	lower
Economic growth	lower	higher

Source: Authors

5. Conclusions and policy recommendations

The paper addresses the question of whether EU policies should head towards autonomy, coordination or harmonization. Taking the path dependence effect into consideration, in the authors' opinion, Europe has gone too far in its integration process to be able to continue with policies implemented fully under the competencies of individual member countries. A substantial change in these trends would incur almost prohibitive costs. Furthermore, the high level of monetary unification, having already been accomplished, in fact, considerably excludes fully autonomous fiscal policies. On the other hand, Europe is still too heterogeneous and it will also be so in the future, simply because of the fact that people in Ireland, Hungary, Portugal or Sweden are different, have a distinct mentality, culture, traditions, social relations and ways of thinking. Therefore, a goal-directed top-down harmonization path towards full unification is neither reasonable nor realistic. On the contrary, it could even be contradictory, since it could increase people's antipathies towards the European integration process itself.

For these reasons, we propose that the European Union should officially declare that, within the European integration process, there is not one goal to achieve absolute harmonization in all areas; instead, an adequate level of coordination in each particular policy area should be sufficient. What does this mean in the fiscal areadiscussed in this paper? A fiscal union in the current form of the EU is neither politically enforceable, nor economically rational. On the other hand, in order to keep the

European integration process viable, it is necessary to reduce behaviour with features of moral hazard and free ride and strengthen joint responsibility for the fiscal development of public finances in the EU.

Regarding the recent efforts to strengthen coordination and discipline in the fiscal area, e.g., by modifying the Stability and Growth Pact (SGP) with the Fiscal Compact, The Six-Pack, European Semester and other economic policy coordination initiatives in the EU, one might hardly assume to what extent fiscal policy converges and what is the influence on the fiscal discipline in the upcoming future. Unfortunately, the adherence of most of the directives and initiatives is binding mostly due to sanctions of a financial nature, or they are not binding at all, since they are just recommendations. This is one of the main critical arguments against the SGP in literature (Annett, Deppler and Decressin, 2005; De Haan, Berger and Jansen, 2003, De Grauwe, 2012). In particular, the exercise of financial sanctions against countries with deficit of public finance makes their budgetary problems worse. In addition to this, these financial sanctions can be easily interpreted by national politicians in the sense that the EU is a culprit or accomplice of a country's budgetary problems. As a consequence, doubts about the better functioning of the new schemes naturally arise. Therefore, the paper suggests implementing additional sanctions, which are of a more institutional nature. In this sense, we propose (re-)considering the following measures:

- a partial, temporary limitation of a country's voting right at particular summits, councils, meetings of ECOFIN, Economic and Financial Committee, Economic Policy Committee etc.
- public hearings in national parliaments in countries, which break the joint provisions on fiscal discipline, moreover, under attendance of representatives of a certain EU economic body

These two proposals head towards the creation of an uncomfortable setting for national politicians who are responsible for breaching common agreements. The former means particularly a symbolic limitation of politicians' power, the later should attract more attention in the country's media to a particular problem, therefore also increasing the pressure on national politicians' responsibility. Being willing to be more courageous and, in the authors' view, more efficient in terms of the impact on public monitoring of fiscal responsibility, it is possible to deal with such alternatives as a deduction of points in the UEFA competitions (e.g. in a qualification group to the European championship) and the other event of a similar importance.

Besides the matter of joint responsibility, we point out the open coordination method to be an approach, which is in accord with the paper's line of argumentation. We are in agreement with Zeitlin (2005) that it may be a sustainable alternative path between a fragmented Europe and a European super state. The open coordination method can be suitable both for the fiscal area and for the considerably heterogeneous areas of welfare states and social policies, which are other fundamental obstacles to the formation of a fiscal union in the contemporary European Union.

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Project Information

Welfare, Wealth and Work for Europe

A European research consortium is working on the analytical foundations for a socio-ecological transition

Abstract

Europe needs change. The financial crisis has exposed long-neglected deficiencies in the present growth path, most visibly in the areas of unemployment and public debt. At the same time, Europe has to cope with new challenges, ranging from globalisation and demographic shifts to new technologies and ecological challenges. Under the title of Welfare, Wealth and Work for Europe – WWWforEurope – a European research consortium is laying the analytical foundation for a new development strategy that will enable a socio-ecological transition to high levels of employment, social inclusion, gender equity and environmental sustainability. The four-year research project within the 7th Framework Programme funded by the European Commission was launched in April 2012. The consortium brings together researchers from 34 scientific institutions in 12 European countries and is coordinated by the Austrian Institute of Economic Research (WIFO). The project coordinator is Karl Aiginger, director of WIFO.

For details on WWWforEurope see: www.foreurope.eu

Contact for information

Kristin Smeral

WWWforEurope – Project Management Office

WIFO – Austrian Institute of Economic Research

Arsenal, Objekt 20

1030 Vienna

wwwforeurope-office@wifo.ac.at

T: +43 1 7982601 332

Domenico Rossetti di Valdalbero

DG Research and Innovation

European Commission

Domenico.Rossetti-di-Valdalbero@ec.europa.eu

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