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"Regulation or capacity for the EU's fiscal future? From the Werner and McDougall reports to the current conjuncture"

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Abstract:

The covid19 crisis has thrown wide open the debate on EMU's future. NGEU has broken the stalemate over a central fiscal capacity. The open question is whether NGEU is a one-off or a first step. The suspension of the stability pact has given new urgency to the debate on reforming EMU's fiscal rules. The open question is how the pact's rules should be relaxed. Yet, there is no debate about how these two prospects relate to each other. This paper argues that the temporal coincidence of these two developments should prompt a more wide-ranging debate about the overall structure of EMU. A permanent central fiscal capacity and a reformed pact should be seen as alternatives. I make two claims: first, a fiscal capacity renders a reformed pact unnecessary and second, that is an optimal solution politically. A fiscal capacity would provide an efficient asymmetric shock absorber and so reduce the need for pre-emptive action against negative cross-border externalities. It would also provide an abundant supply of an EU-wide safe asset around which to structure the EU's financial system, thus rendering unnecessary the backstopping of member states' debts. This would restore democratic accountability while eliminating moral hazard and enforcement problems.

La crise du covid-19 a rouvert le débat sur l'avenir de l'UEM. Le programme NGEU a remis sur les rails la perspective d'une capacité fiscale centrale. La question ouverte est de savoir si NGEU est unique ou bien la première étape vers une capacité permanente. La suspension du pacte de stabilité a revigoré le débat sur la réforme des règles fiscales de l'UEM. La question ouverte est comment assouplir les règles du pacte. Pourtant, il n'y a pas de débat sur la façon dont ces deux perspectives s'articulent entre elles. Cet article soutient que la coincidence temporelle de ces deux développements devrait susciter un débat d'envergure sur la structure d'ensemble de l'UEM. Une capacité fiscale centrale permanente et un pacte réformé devraient être considérés comme des alternatives. Je soutiens deux propositions: d'abord, une capacité fiscale rend un pacte réformé inutile et, ensuite, que c'est la solution politiquement optimale. Une capacité fiscale fournirait un amortisseur efficace contre les chocs asymétriques et ainsi réduirait le besoin d'action pré-emptive contre les externalités négatives transfrontalières. Elle fournirait également une offre abondante d'un "safe asset" paneuropéen autour duquel se structurerait le système financier européen, rendant ainsi inutile la garantie apportée par la BCE aux dettes publiques des Etats-membres. Ceci restaurerait la responsabilité démocratique et ainsi éliminerait l'aléa moral et les problèmes d'enforcement.

Keywords: fiscal rules, fiscal capacity, EMU

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Regulation or capacity for the EU's fiscal future? From the Werner and McDougall reports to the current conjuncture

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Introduction

Economic policy developments in the European Union since the spring of 2020 have been momentous. The previous stalemate on common borrowing, an EU fiscal capacity and transfers to weak member states was broken in the summer of 2020, through the decisions first to launch SURE and then the much more consequential (but temporary) NGEU. These two schemes together will enable the Commission to borrow more than a trillion euros in current euros by the mid-2020s, turning it into the fourth biggest sovereign borrower in the EU after Germany, Italy and France. The war in the Ukraine has added momentum in the same direction. The French and Italian leaders have argued for a new "resilience" scheme to weather off its economic consequences (Höfling 2022), a call echoed by the French and Italian commissioners (Breton and Gentiloni 2022). As of October 2022, the German government had not ruled out such a development (von der Burchard 2022). Meanwhile, financial investors keep urging further EU borrowing (Jones 2022).

In a much less salient development, the crisis has also led to a protracted suspension of the Stability and Growth Pact (SGP) and an official debate over its reform. The Commission first launched an official review process of the rules in early 2020, then activated the General Escape clause in March 2020. The war in the Ukraine has led to the suspension of the pact for yet another year, until 2024. The pact is thus likely to remain suspended for almost the entire duration of the current (2019-24) legislature.

These developments were ostensibly in response to a severe crisis construed as a symmetric shock not entailing moral hazard considerations (Crespy and Schramm 2022), now prolonged by a second such shock in the shape of the war. Yet, there is a clear sense among policymakers and commentators that they represent durable turning points. The debate is whether NGEU should lead to a permanent EU fiscal capacity with common borrowing and new European taxes. As for the SGP, the Commission's refusal to reinstate the rules in their previous form, and the lack of any serious political opposition to that decision, are a clear indication of the widespread acknowledgement of their inadequacy during both bad and good times.

What is striking, however, is that there is no debate on how these two prospects – a permanent EU fiscal capacity and reformed fiscal rules – relate to each other. At a level of greater theoretical abstraction, there is no debate whatsoever on the articulation between fiscal federalism on the one hand and the set of fiscal rules embodying macroeconomic coordination on the other.

There is one indirect exception to this assessment, however, namely the comparative literature looking at other fiscal federations in an attempt to draw lessons for the EU (e.g. Cottarelli and Guerguil 2015). Several of these contributions note the fact that the United States does not have any kind of binding fiscal rules embodying economic policy coordination between the Union's States. They also note that this is probably explained by the existence of a fiscally very large federal government that fulfils the function of macroeconomic stabilization and supplies the system's key safe asset (US Treasury bonds). However, only one such comparative contribution focuses explicitly on this aspect of the EU-US comparison, namely Mark Hallerberg's explanation (2014) for the different mixes of fiscal capacity and regulation in the American and European Unions. Hallerberg finds that the existence of extensive federal capacity in the US renders regulation of subfederal fiscal policy unnecessary, and that it is precisely the lack of such capacity that explains the EU's experience with fiscal rules (regulation). In an IMF-commissioned

book-length study comparing the EU to existing federations, the authors also come to a similar conclusion (Cottarelli and Guerguil 2015, p11)[1].

In this paper, I argue that this is a fundamental debate for sketching out medium- and long-term prospects for the institutional evolution of the EU. The temporal coincidence of these developments and the policy debates they have triggered, as well as the more general debate on the need for treaty change (Politico 2022), should indeed be seen as an invitation for scholars and policymakers to reflect on their articulation. How should a permanent EU fiscal capacity and a set of fiscal rules relate to each other? Do they fulfil distinct policy functions justifying their parallel existence? Or should they be viewed as alternative institutional arrangements for achieving largely the same goals, which implies that having both is unnecessary? Finally, what are the implications in terms of democratic legitimacy of each solution? I will claim that fiscal federalism (capacity) and macroeconomic policy coordination (regulation) should be construed as alternatives and that the former is economically and politically the superior alternative.

Debate on institutional design of monetary unions tends to be conceptually organised by reference to optimum currency area theory (Hafner and Jager 2013). OCA theory essentially asks how macroeconomic stabilization and interregional equilibrium can be achieved in a monetary union given that the policy instruments of nominal exchange rate and interest rates are no longer available to individual regions within the union. In terms of fiscal policy, this amounts to concentrating on just one of the three policy functions of modern fiscal policy (macroeconomic stabilisation, capital allocation and income redistribution; Musgrave 1939). Although the same policy instruments can fulfil more than one function (unemployment compensation for example is both a typical stabilisation and redistribution instrument), this paper focuses on how the two alternatives perform in relation to stabilisation.

To this, however, should also be added the task of macrofinancial stabilisation. One strand of research argues that the Eurozone crisis was not so much a crisis stemming from macroeconomic

imbalances as a financial crisis caused by unsustainable financial practices and an institutional design that encouraged capital flight under conditions of fiscal stress in member states (e.g. Jones 2015). This line of thinking argues that the Eurozone needs reforms to shore up financial stability, including banking union, tougher microprudential rules and supervision and an increased provision of safe assets.

The argument about coordination and fiscal capacity as alternative solutions to the stabilisation problem is not new. Indeed, in a way, it was a feature of the early official debates on EMU in the 1970s. The 1970 Werner report and the 1977 McDougall report each embody a view of EMU based on one of the two alternative arrangements. The next section of this paper offers a summary of their conceptions as a way of highlighting both the relevance but also the sense in which this is a long-standing debate now coming into focus due to actual political developments. The following section looks at subsequent developments in EMU to highlight how the McDougall report's vision fell by the wayside until the Eurozone crisis revived its rationale while the Werner report's was reduced to the SGP. The subsequent two sections lay out the arguments in favour of capacity over regulation. The paper then concludes.

Werner or McDougall

In many ways, the debates of the 1970s around EMU are highly instructive. The field of concrete political possibilities had not yet narrowed based on the member state preferences that gradually congealed under the weight of successive currency crises over the next twenty years. As a result, the debates reflected a greater degree of intellectual and political ambition – both in proposals for a system of coordination in the Werner report and a fiscal capacity in the McDougall report. As I will show, most of the innovations proposed over the last ten years on both fronts can be found in the reports of the 1970s.

The Werner report was commissioned by the Council following the Hague Summit of December 1969 and prepared in 1970 by top-level bureaucrats under the chairmanship of Pierre Werner, Luxemburg's prime and finance minister (Danescu 2016). It was thus very much an intergovernmental initiative, which probably explains why it focused on coordination when discussing the economic side of EMU. The report began by noting how the completion of the customs union would mean that "general economic disequilibrium in the member countries will have direct and rapid repercussions" on the Community as a whole and that "the increasing interpenetration of the economies has entailed a weakening for national economic policies" (Council – Commission 1970, 8). It thus started from the basic premise that informs theoretical debate on macroeconomic policy in a federal union. Moreover, the report noted that by the time monetary union kicked in, the Community's budget would "still be weak compared with that of the national budgets", meaning that "[their] harmonized management … will be an essential feature of cohesion" (ibid, 11).

How would that work in practice? The report projected the creation of new powers at the Community level, embodied in a "centre of decision for economic policy" that would "*in accordance with the Community interest* … influence the national budgets, especially as regards the *level and the direction of the balances* and the methods for *financing the deficits or utilizing the surpluses*." (ibid, 12-13; italics mine). This new institution would furthermore be politically responsible to a directly elected European Parliament.

These citations highlight that binding fiscal policy coordination would be a key mechanism for managing the disequilibria arising from growing market integration. Coordination would proceed by first defining an overall policy for the Community as a whole. Member state fiscal policies would flow from that Community-wide objective, for member states with both budget deficits and surpluses. Although the report did not discuss the decision-making procedures in detail, the suggestion that the European Parliament would be involved hints at codecision. This entails that

decisions would be binding on member states, with democratic legitimacy flowing from the European Parliament's involvement.

The McDougall report (Commission 1977) was published in 1977. It was named after Scottish economist Donald McDougall, who chaired a group of academic experts at the Commission's request to study EMU's implications for public finance. It drew on the then emerging theory of fiscal federalism[2] and on detailed empirical analysis of inter-regional fiscal transfers in federations and the largest unitary states of the Community. It argued that in a future monetary union, a minimum federal budget of 5% - 7% of Community GDP would be necessary to manage imbalances that would inevitably arise under single market conditions and that could not be corrected using trade barriers or nominal exchange rate adjustments. The report advocated instruments specifically designed for managing asymmetric shocks (a Community unemployment fund, cyclical grants to local governments and a conjunctural convergence facility) and included these in its "pre-federal integration" scenario that would entail a Community budget of around 2.5% of GDP. Such was the conviction of the study group that a federal fiscal capacity was a *sine qua non* of EMU that most of its members considered a 5% to 7% GDP budget to be a prerequisite for introducing a single currency[3].

It is clear from the above that coordination (regulation) and a substantial federal budget (capacity) were seen as alternatives. The Werner report was clear that binding coordination would be necessary given the absence of such a budget, whereas the McDougall report did not even bother considering whether coordination was a feasible choice. Both reports evince a common preoccupation with managing the imbalances and asymmetric shocks that would arise due to the completion of the customs union and both consider that doing so entailed new federal powers – either of regulation for the purposes of binding coordination or of outright fiscal capacity for direct policy action.

From the Werner and McDougall blueprints to the current debate: A (very) concise history of fiscal policy institutions in EMU

These blueprints have never been implemented due to political constraints. Only since the Eurozone crisis have proposals inspired by them been put on the agenda.

The McDougall recommendations never made their way onto the EU's official policy agenda and the report barely features in even the best histories of EMU[4]. The report's spirit was upheld in the academic community and helped nourish considerable scepticism among American economists regarding the prospects of the single currency (Jonung and Drea 2009). Only with the four presidents' report (van Rompuy 2012) in the context of the Eurozone crisis did the proposal for an EU fiscal capacity (vaguely) feature for the first time in an official agenda-setting document of the European Council. Simultaneously, the French and Italian Treasuries revived the proposal for a European Unemployment Benefit Scheme, an idea also promoted by the Commission[5]. Then, in 2015, French Economy minister Emmanuel Macron and German vice-chancellor Sigmar Gabriel called for a substantial Eurozone budget and common borrowing (Macron and Gabriel 2015), a proposal that Macron offered again in 2017, this time as French president. NGEU is the result of this decade-long debate, which has now moved to whether to move to a permanent fiscal capacity.

The Werner blueprint was reduced to the SGP's fiscal rules. The change in approach was already perceptible in the Delors report. Although the document paid lip service to the notion of a "Community-wide fiscal policy stance ... through the coordination of national budgetary policies", it only proposed rules to "impose effective upper limits on budget deficits of individual member states" (CSEMU 1989, p20). This might sound like a mere nuance, but the two coordination systems involve fundamental differences.

The SGP was inspired by the growing body of academic work and policy experiments with fiscal rules designed to contain the growing budget deficits experienced across the developed world from the mid-1970s onwards (Poterba and von Hagen 1999 and Hallerberg 2004 on EU member states). But it also, to some extent at least, shared the rationale of the Werner blueprint, namely that in a monetary union with a high degree of economic interdependence, cross-border spillovers were likely and called for some form of coordination that would ensure compliance with principles of fiscal discipline. In fact, the SGP has to be understood in tandem with articles 123 and 125 TFEU, respectively prohibiting the ECB from directly financing member states and the EU and its member states from assuming each other's fiscal liabilities. These articles were designed to prevent bailouts of fiscally imprudent member states, either by the ECB (monetisation) or other governments in the Union (mutualisation). There were two reasons for this. First, avoiding a bailout by the ECB was conceived as preventing "fiscal dominance" (Schnabel 2020), namely a situation where the central bank is forced to support the government's fiscal policy to the detriment of its mandate, namely price stability. Second, both articles were supposed to prevent "fiscal integration by default" (Schelkle 2014), whereby without an explicit political and constitutional decision on the part of the member states, fiscal liability would be partly mutualised, either through the central bank's balance sheet or the outright assumption of liability. Articles 123 and 125 were also meant to convey to investors that member states in fiscal straits would not be bailed out. Investors would then price in the default risk of the member states and thus create a system of market discipline for the governance of the sovereign debt market in the EU. The SGP was added onto this construction as an additional mechanism designed to ensure fiscal discipline.

The Maastricht setup reflected relative bargaining power among member states (Moravscik 1998). Its emphasis on policing deficits instead of striking a balance between the budget balances of the member states reflects the demand by the dominant strand in German public opinion for

safeguards that fiscal policy in the weak currency member states would not lead to negative spillovers. But German public opinion and politicians were unwilling to give up even a modicum of their policy autonomy by agreeing to have the Commission influence strong currency member states' policies too.

In this respect, the Werner blueprint and the SGP embody two distinct models of coordination for preventing and managing asymmetric shocks and spillovers. The first is based on the principle of binding coordination deriving from a policy designed at the collective level. The second bets on the aggregation of individually sound fiscal policies and thus on the prevention of any spillover and the assignment of macroeconomic stabilization to member state fiscal policies. In the Werner blueprint, the burden of absorbing an asymmetric shock can be shared between the members of the union. If a member state suffers a local recession or needs to adjust by depressing its price and wage level, the federal decision-making body orders that member state to consolidate its finances while also ordering those member states with a surplus to embark on fiscal expansion. The additional advantage in such a situation is that the aggregate fiscal policy stance is not procyclical and the system does not generate a deflationary bias. Under the SGP, shocks can only be absorbed by national fiscal policy action. But there is no specific provision in the SGP for absorbing asymmetric shocks. These must not occur, and the rules were meant to ensure they did not.

The Eurozone crisis and its aftermath offered a damning verdict on the SGP. In that context, the SGP failed in two fundamental ways. First, it failed to prevent the occurrence of asymmetric shocks. In particular, it failed to prevent the accumulation of macroeconomic imbalances prior to the crisis and the asymmetric shock generated by the unwinding of those imbalances after 2008. This was not (only) because the pact's rules were broken and then watered down in 2003-5, an occurrence that highlighted the compliance and enforcement limits built into the structure of the system (Rae Baerg and Hallerberg 2016)[6]. It was mostly because the pact was not designed

to pick up the right signals and induce relevant policy action. Spain and Ireland are the basket cases in this respect. Both member states were among the fiscally best-behaved students in the class. They both respected by some distance the deficit and public debt criteria. But they were nonetheless accumulating imbalances through other channels, namely private sector capital imports that funded property bubbles that started bursting around 2008. When they did, capital fled and the scale of the banking crises was far too big to be tackled by the fiscal resources available to the governments. Spain and Ireland thus ended up in fiscal crisis despite fully complying with the rules. Bailouts followed that were supposed to be unnecessary and proscribed under the SGP.

Second, the SGP failed to efficiently absorb the shocks when these occurred in 2010-12 because the notion that national fiscal policy could be used for stabilization purposes proved wrong. With the Eurozone's peripheral member states having to adjust while also having no national fiscal space available for boosting public investment, the SGP offered the EU no instrument through which to enforce burden sharing with the member states of the North that had been accumulating current account surpluses and had plenty of fiscal space for expansion. The result was a deeply asymmetric adjustment process (Frieden and Walter 2017) and a procyclical deflationary bias in the EU's overall fiscal stance in 2011-14, precisely when the economy was double dipping into recession (Commission 2016, p12).

Following these failures, there was a recognition that the SGP needed to move closer to the Werner blueprint. The Two-Pack Regulation introduced in 2013 acknowledged that the Eurogroup should discuss fiscal policy in the Eurozone as a whole. The 2015 Five Presidents' Report went further by proposing that the European Semester should begin with a discussion of the Eurozone's overall situation (Juncker 2015, annex 2). This would follow the newly created European Fiscal Board's annual report containing advice on fiscal policy for the Eurozone as a whole. The Commission (Buti 2016 lays out its thinking) then introduced the notion of the

aggregate fiscal stance of the Eurozone, prompting a debate in policy-making and academic circles (e.g., ECB 2016; Freitag and Stosberg 2018). In November 2016, the Commission announced that it would generate its country specific recommendations based on an evaluation of that aggregate fiscal policy stance (Commission 2016). But while recommending a fiscal expansion to the tune of 0.5% of Eurozone GDP to be carried out mainly by boosting spending by the Dutch and German governments, it simultaneously acknowledged that it could only recommend, not enforce, such expansion (Commission 2016, p2-3). The German finance minister, Wolfgang Schäuble, was quick to point this out and add that the SGP applied to member states individually, not to the Eurozone as a whole (Reuters staff 2016). The political constraints that had reduced the binding and symmetric coordination system of the Werner report into the unenforceable and asymmetric SGP were still operational in that respect. Apart from this ill-fated initiative by the Commission, the debate on reforming the SGP has veered between strengthening the enforcement mechanisms (the 2010-13 reforms known as six- and two-packs) and ring-fencing public investment from the fiscal discipline involved in the pact (this is the main thrust of the debate since 2020)[7].

The enforcement gap and the democratic impasse of effective coordination

This (very) concise history of the SGP underlines the political constraints that render optimal coordination à la Werner out of reach given the current system. First, the SGP as it stands is asymmetric because its rules and enforcement mechanisms only target member states with budget deficits, not surpluses. The member states with surpluses evince no inclination to be willing to submit to instructions from the Commission. Second, given how ineffective these mechanisms are in eliciting compliance from member states with deficits that are widely perceived as "sinners", it seems fanciful to believe that the same mechanisms could ever induce member states with surpluses (the "saints" in the same moralistic narrative – Dyson 2014;

Matthjis and McNamara 2015) to adjust policy in line with Commission recommendations. Even if the SGP's rules were formally reformed along the lines of the Werner blueprint, giving the Commission the possibility to initiate sanctions against surplus member states, there is ample evidence to conclude that the policy prescriptions for individual member states would frequently go unimplemented.

This inherent enforcement and compliance gap to a coordination system based on fiscal rules has prompted several prominent policymakers to toy with the idea of greater capacity at the central level. None has put the case with more intellectual clarity than former ECB president Mario Draghi. In a 2015 speech, Draghi (2015) argued that the alternative was between rules and "institutions", by which he meant endowing the central level of government with "executive power" to implement economic policies in the member states. Although pitched at a high level of abstraction and providing no operational details, the concept put forward by Draghi is akin to the one in the Werner report. Marco Buti, the Commission's Director-General for Economic and Monetary Affairs (2008-19), also promoted the concept and claimed that the Commission's initiatives on a Eurozone fiscal stance were a small, albeit largely symbolic, step in that direction (Buti 2016, 191-193).

To the best of my knowledge, there have only been two substantive proposals by senior policymakers for moving from rules enforceable *ex-post* through sanctions to executive capacity. Jean-Claude Trichet, then-ECB president, suggested during the Eurozone crisis creating a "Eurozone finance minister" (Trichet 2011) and supplementing the SGP's enforcement mechanisms with "economic and fiscal federation by exception" (Trichet 2013). Member states subject to the Excessive Deficit Procedure that would repeatedly refuse to follow the Commission's recommendations would be dispossessed of their economic policy powers to the benefit of the federal level (the "Eurozone finance minister"). Economic policy in the member state would be decided according to the ordinary legislative procedure[8]. In Trichet's view, this

would lend the system democratic legitimacy since the European Parliament would be involved in the decision-making process. Similarly, in 2011-12, Wolfgang Schäuble, German finance minister, advocated giving the Commissioner for economic and monetary affairs the power to veto national budgets that breached the SGP's rules (this became known as the "super-commissioner" proposal). Draghi backed the proposal (Schoeller 2019, 71-92). Both proposals were attempts by those stakeholders in the system with the most interest in enforcing fiscal discipline to close the enforcement gap mentioned above.

Trichet and Schäuble were not focusing on how to move the SGP closer to the Werner blueprint. But their proposals indicate the kind of political issues that would be thrown up by an institutional solution to the enforcement problem of fiscal rules.

Trichet's proposal caused a stir, never gained traction and quickly disappeared from informed debate about institutional reform. Schäuble's was not even supported by the Commission and similarly failed to make it onto the reform agenda. It is not difficult to see why. The notion that member states would be dispossessed to various extents of their fiscal powers was profoundly alien to audiences for whom input legitimacy concerns take precedence over output legitimacy[9].

In his 2013 contribution, Trichet tried to address this issue by bringing the European Parliament into the decision-making procedure. In this respect, he was returning to a key feature of the Werner report itself, which envisaged that directives to member states would be codecided by the European Parliament. In both cases, this reflects the logic of Rittberger's theory of the "democratic spillover" (2003, 2005). Rittberger argues that because the dominant conception of liberal democracy in Europe is based on a particular conception of parliamentarism, normative pressure builds up for granting powers to the European Parliament every time integration transfers powers from the member states to the EU through adoption of qualified majority voting. Rittberger sums this up as "no integration without representation".

Yet in this case, bringing the EP into the decision-making loop fails to address the issue of input legitimacy. Involving a directly elected legislature in policy-making is only one aspect of the problem. Another is the jurisdictional alignment between the decision-making institutions and the fiscal policies pursued. “No taxation without representation” (the original slogan Rittberger tweaks in developing his theory) implies that the voters who get taxed are also the ones represented in the decision-making legislature. Indeed, a well-known feature of the 2010-15 bailouts is that they lacked input legitimacy despite having been adopted by the legislatures of the bailed out member states (which gave them some degree of formal member state ownership). The member state legislatures were so constrained that their adoption of the measures demanded by their creditors was a mere formality – the real decision-making power lay elsewhere, namely with executives at EU level (Commission, ECB) and member state level (Eurogroup). That sequence gave rise to a broad literature on the turn towards “executive federalism” (Habermas 2012, Crum 2013, Snell 2016) – a term used to convey the fact that the centralisation of economic policy-making during the Eurozone crisis had benefitted executives over legislatures and thus had detrimental effects on representative democracy and, consequently, on input legitimacy.

This, in short, is the crucial problem bedevilling any system based on binding coordination of member state fiscal policies: the dealignment of the level of decision-making (federal) and the level of policy implementation (member state). This problem cannot simply be argued away by claiming that democratic legitimacy for the aggregate fiscal stance would provide sufficient cover and that interdependence and spillovers give member states a legitimate say over each other’s policies. Fiscal policy in the EU (and in any other federal union) is not simply about providing macroeconomic stabilization at the aggregate level. It also encompasses other policy objectives, most of which are not best fulfilled at the central level and typically are not (Cottarelli and Guerguil 2015, chapter 1), such as education, housing, health, infrastructure and culture. Indeed, the core prescription of the theory of fiscal federalism (Oates 1972) flows from the so-called

“decentralization theorem”, which states that whenever policies do not involve cross-local externalities, they should be pursued by the lowest level of government possible to accommodate preference heterogeneity among voters. Efficiency in taxation and spending will flow from the mobility of factors of production and citizens who will “vote with their feet” when local governments over-tax and misspend.

The experience of the adjustment programs for peripheral member states in 2010-15 has shown that when the federal level takes over with the simple aim of carrying out fiscal consolidation, it is forced to make detailed decisions about taxation and spending at the member state level that have redistributive consequences domestically and for which the federal level cannot possibly have a mandate. If the federal level were given “executive powers”, whether in exceptional or normal circumstances, it would then have to make decisions with no immediate relation to the aggregate macroeconomic stabilization objective pursued. Reducing the fiscal deficits or surpluses of an unwilling member state would involve decisions about which taxation and spending items to cut or raise.

In more conceptual terms, the democratic problem of federal executive authority over member state fiscal policies stems from the lack of overlap between policy functions and instruments. Because the distinct policy functions of modern fiscal policy (stabilization, allocation and redistribution) are analytical constructs, they do not correspond to distinct policy instruments that could be separately manipulated by distinct levels of government. The same instruments typically fulfil several functions. This multi-function quality of distinct fiscal policies means that the federal level of government would be fulfilling functions that it would not be democratically legitimised to pursue, even if one accepts the argument about spillovers creating a legitimate stake for the Union as a whole in each of its components’ fiscal policies.

To put it in simpler terms, an efficient Werner-like coordination system that would overcome the enforcement gap of rules-based systems would be tinged with authoritarian centralism. This

accounts for why the historical record in other federations shows that "direct controls from the central government are relatively rare (this is an important difference between federations and unitary states) and mostly appear following an extended breach of fiscal targets or a severe subnational fiscal crisis that requires sizable financial support from the center" (Cottarelli and Guerguil 2015, p7). This fits well with the experience of the bailouts during the Eurozone crisis but is hardly a recipe for a permanent system of fiscal policy coordination. One cannot treat the EU's member states as if they were administrative regions in a unitary state like France.

The advantages of a permanent fiscal capacity

The McDougall blueprint would solve both problems identified in the previous section (enforcement gap and authoritarian centralism) and would involve several other political advantages as well. Such a capacity could be designed in such a way as to minimise the moral hazard involved in fiscal federalism (Rodden 2002, 2005) but also the moral hazard involved in the current arrangements whereby the ECB is backstopping member state debt increasingly unconditionally. In terms of democratic legitimacy, a permanent fiscal capacity would not only solve the dealignment problem identified above but would also potentially improve both input and output legitimacy.

1. A permanent EU fiscal capacity would provide a substantial and effective asymmetric shock absorber. This entails abandoning the unrealistic ambition of preventing the accumulation of macroeconomic imbalances between the member states and the cross-border spillovers these tend to generate as well as the equally unrealistic notion that only member state fiscal policies should be tasked with macroeconomic stabilization[10]. Such a budget would provide a more efficient shock absorber than would the Werner blueprint because it would eliminate the time lag involved in coordinating and implementing a policy response among the member states. This

would especially be the case if the fiscal capacity were based on automatic stabilisers (income taxation on the revenue side and automatic spending obligations such as unemployment insurance on the spending side). For macroeconomic stabilization purposes, both the McDougall report and the recent IMF study show that variations in net (as opposed to gross) interregional transfers do much to absorb asymmetric shocks and that these net transfers are a small percentage of GDP. This means that an effective shock absorber could be designed by shifting only small amounts of highly output-sensitive overall revenue and spending from the member states to the federal level. Indeed, such proposals – for example, a corporate income tax on large corporations and an unemployment benefits scheme – are already on the policy agenda.

NGEU's design, in this respect, is suboptimal as a blueprint for a potentially permanent capacity. NGEU (in particular its core component, namely the Recovery and Resilience Facility) was primarily designed to benefit those member states that had been accumulating economic difficulties prior to the pandemic (Armigeon et al 2022) by extending them conditional grants and loans for public investment in specific areas (green transition and digitalization). This is an attempt to address interregional stabilization issues by policies best designed to address macro-cohesion and structural convergence problems. Moreover, the specific criteria for the distribution of grants and loans were the object of intense bargaining in the European Council (de la Porte and Jensen 2021), a process driven at least as much by all sorts of domestic political considerations in the member states as by the logic of crafting an optimal asymmetric shock absorber (Howarth and Quaglia 2021). Such a process based on inter-member state negotiations inevitably intensifies the political tensions deriving from the interregional redistribution of resources involved in any asymmetric shock-absorbing scheme. An alternative based on automatic stabilizers would help couch the problem in terms of redistribution among functional interest groups (say the corporate sector vs the unemployed) across the EU, which would allow

framing the debate in terms of the traditional left-right cleavage (i.e. ideological, not territorial, politics; see Hix, Noury and Roland 2007, chapter 3).

2. A permanent fiscal capacity would overcome enforcement issues. Although exceedingly small, the EU budget is implemented without compliance issues. The European taxes (customs and excise duties and the European VAT) that provided around a quarter of the EU budget's resources in 2014-20 are consistently and seamlessly raised by member state taxation authorities. There is no reason to consider that a greater volume of fiscal resources would create compliance problems. New European direct taxes could be raised following the same "piggybacking" pattern by which the European VAT is. Such piggybacking is indeed a typical feature of federal fiscal systems (Bird 1999). The option of increasing member state contributions is not on the table (it has been excluded from consideration regarding the revenues that will help repay the NGEU-related debt from 2028 onwards). Indeed, given the contentiousness in net contributors such as Germany and the Netherlands of these contributions, the political obstacles such an option would raise would appear substantial.

On the spending side, the budget is mostly executed conjointly by the Commission and the member states while scrutinised by both the European Parliament (through the discharge procedure) and the Court of Auditors. These institutions tend to approve the execution of the budget by the Commission (Commission 2021), despite concerns about fraud relating to EU budget funds. Recent anti-fraud efforts as well as the establishment of the European Public Prosecutor's Office (EPPO) are leading to a decline of fraud against the budget (OCCRP 2021). The NGEU blueprint based on conditional grants and loans offers another lever against misuse of EU budget funds through the conditionality attached to the disbursement of the funds.

3. A permanent fiscal capacity would provide a steady stream of supranational safe assets (van Riet 2021) that could gradually come to dominate the sovereign debt market in the EU (Cabral 2021). This would have a stabilising effect on the financial system and would fulfil the function

of macrofinancial stabilisation. Financial investors are clamouring for more high-grade European sovereign debt because of the dearth of existing AAA-rated member state bonds and are clear that the only viable solution is more EU-issued debt backed by the EU budget along the NGEU model (Tooze 2021, 187; Jones 2022).

But it would also hold out the promise of no longer having to backstop the sovereign debts of the member states, either through the ECB's bond buying programmes or the deployment of the European Stability Mechanism[11], an issue that has been a major source of controversy since 2010. The core conflict of the Eurozone crisis was indeed whether to ensure that member state debts were safe assets, which entailed various forms of fiscal liability mutualisation, or whether to enforce the system of market discipline set up at Maastricht by introducing orderly procedures for debt restructuring (private sector involvement as this was called). The corporate sector pushed back at the German government and its allies' insistence on market discipline and obtained the promise of potentially unlimited backstopping via the ECB's balance sheet (Georgiou 2022). The ECB's swift reaction in March 2020 to launch the Pandemic Emergency Purchase Programme (PEPP) and its announcement of the new "Transmission Protection Instrument" (TPI) in July 2022 show that the policy commitment of ensuring the risk-free status of all member state debt has become firmly entrenched, unlimited and even unconditional. Yet, this commitment has not resulted from a democratically legitimised decision-making procedure and is arguably contrary to the spirit of the treaties.

Interestingly in relation to the widespread argument associated with Rodden's work that fiscal federalism involves moral hazard leading to unsound subfederal fiscal policies and bailouts, the ECB's henceforth unconditional backstopping of member state debts involves a clear element of moral hazard. Member states can safely pursue their fiscal policies in the knowledge that ultimately they will be backstopped by the central bank's policies (Garicano 2022). The rise of this system in the EU contradicts the basic thrust of Rodden's argument about the dilemma of

fiscal federalism. He argues that fiscal federalism gives rise to imprudent fiscal behaviour by component units of a federation when those units both have autonomous borrowing capacity (evidently the case in the EU) *and* benefit from intergovernmental grants ("vertical fiscal imbalance" in the public finance terminology – evidently not the case in the EU)[12]. In the EU's case, however, the practical need to backstop member state debt arguably stems from the fact that there is no other safe asset in adequate supply in the system for investors to hold (Gossé and Mourjane 2021), a consequence of the very absence of a substantial federal budget. Moral hazard in the EU is the result of the very lack of fiscal federalism, not of its existence.

A permanent fiscal capacity, and in particular one that would do the bulk of counter-cyclical borrowing during downturns, would gradually provide such a supply of supranational safe assets. The share of federal sovereign bonds in financial investors' asset portfolios would gradually overtake that of member state bonds. The risk of allowing a member state to default and restructure its debts would diminish in importance as large investors' exposures to member state debt gradually declined. This would create policy space for reintroducing a system of market discipline for member state debt by abandoning the *ex-post* fiscal liability mutualisation involved in backstopping that debt. A permanent fiscal capacity based on automatic stabilisers would not involve substantial intergovernmental grants and thus could minimise the scope conditions identified by Rodden (2002) and Rodden and Wibbels (2003) as leading to poor fiscal performance and bailouts for subfederal units[13].

4. In terms of democratic legitimacy, a permanent fiscal capacity solves the problem of the dealignment of the level of decision-making and the level of policy implementation by creating space for distinct levels of government to independently pursue distinct fiscal policy functions using dedicated policy instruments. This need not entail distinct types of taxation earmarked for distinct levels of government such that member states would be deprived of specific sources of revenue. The experience of other federations is that the main revenue source for the federal

centre tends to be income taxation (corporate and personal). But subfederal levels of government still regularly collect their own income taxes too for spending priorities that differ from one jurisdiction to the other (Cottarelli and Guerguil 2015, chapter 1), in a pattern that reflects the cross-local heterogeneity of preferences that the theory of fiscal federalism (Oates 1972) identifies as the justification for fiscal decentralisation.

However, a permanent fiscal capacity would entail other issues of democratic legitimacy. In terms of input legitimacy, the decision-making procedure governing the EU budget would have to change in line with Rittberger's argument of the "democratic spillover". Unlike member state budgets, the EU budget lacks the input legitimacy deriving from the full involvement of the European Parliament, such as it is foreseen in the ordinary legislative procedure. The EU budget rests on two distinct procedures. The Own Resources Decision sets the revenue side of the budget. The Commission proposes a draft decision, which the Council must agree to unanimously before member state legislatures can ratify it. The Parliament is only consulted in the process. Arguably, this derives to at least some extent from the fact that the EU budget's resources come in a very large part (above 70%) from member state contributions, which makes it difficult to exclude member state legislatures and to include the European Parliament in the decision-making process. Indeed, the exclusion of the European Parliament in this case is consonant with the democratic impasse I identified as an obstacle to an efficient fiscal policy coordination system à la Werner. On the spending side, the Multiannual Financial Framework is also subject to unanimous agreement in the Council (but not unanimous ratification) but also must obtain the Parliament's consent.

The unanimity requirement for both the revenue and the spending side of the EU budget arguably means that the EU has no autonomous fiscal powers. There is no fiscal integration generating democratic spillover pressures. However, it is difficult to conceive of a substantial permanent fiscal capacity that would function smoothly while being subject to the kind of inter-

member state bargaining that resulted in NGEU, especially one that would no longer be mostly funded by member state contributions but by European taxes. Such a capacity would require autonomous EU fiscal powers, meaning an end to unanimity. In that case, democratic spillover pressures would kick in and formal input legitimacy could only be obtained by moving to the ordinary legislative procedure.

Output legitimacy would also improve because an efficient shock absorber would be introduced and a better aggregate fiscal stance achieved. The EU permanent capacity could go into expansionary mode when member states had to consolidate and thus eliminate the deflationary bias that tipped the Eurozone back into recession in 2011-14. The spectre of a remake of the Eurozone crisis of 2010-12 would be removed as financial investors would not fret over the safety of the bulk of the sovereign debt they would be exposed to. This would entrench the gains of the ECB's decision to backstop member state debt without raising the moral hazard and democratic legitimacy issues that the ECB's actions raise.

One can also make another argument to the effect that a permanent fiscal capacity governed by the ordinary legislative procedure would be beneficial in terms of legitimacy. This relates to the point raised above about couching the debate on an asymmetric shock absorber in terms of the left-right cleavage and not in terms of bargaining between the member states (i.e. in ideological, not territorial, terms. The debate on the EU's democratic legitimacy revolves around the notion of the democratic deficit (for a survey of the positions in this debate, Kohler-Koch and Rittberger 2007). One school of thought (represented most prominently by Simon Hix) argues that the EU's democratic deficit is not so much a function of the (lack of) formal powers of the European Parliament as of the lack of adversarial democratic politicisation of EU decision-making and policies. The argument is that input legitimacy is not simply a function of the formal powers of the European Parliament but also of the extent to which European citizens are actively engaged in EU politics, in particular through their mobilization during European Parliament elections. In

this view, the key to enhancing the EU's legitimacy is to engineer greater citizen involvement in the process of EU decision-making. This means focusing media attention on EU affairs, promoting participation in European Parliament elections, transforming these from "second order" (Reif and Schmitt 1980; Marsh 2020) to "first order" elections and strengthening the "electoral connection" (Hix and Hagemann 2009) between voters and MEPs[14].

The Eurozone crisis was a substantial spur to politicization (Hutter and Kriesi 2019) due to its salience and its large and explicitly redistributive consequences. Political scientists tend to see redistributive policies and in particular taxation and spending as among the issues voters care most about. Participation in the 2014 European Parliament elections stopped decreasing (as it had done in almost every single election since 1979) and then rose sharply in 2019. Analysis of the 2019 elections suggests that the politicization of the previous decade led to something like a "first-order breakthrough" (Plescia et al 2020). A permanent fiscal capacity would represent an entrenchment of the redistributive and fiscal politics unleashed by the Eurozone crisis and thus of the politicization and its effects on the electoral connection that the crisis gave rise to. By raising the stakes of EU policies, such a capacity could thus have beneficial effects on the EU's legitimacy.

Conclusion

I started this paper by arguing that the covid19 crisis has led to a crossroads in terms of fiscal policy institutions in the EU. This is because the introduction of a temporary EU fiscal capacity (NGEU) and the suspension of the fiscal rules (SGP) have significantly altered the terms of the policy debate. Yet, the peculiarity of the ongoing debate is that there is little, if any, reflection on how these two arrangements (capacity vs regulation) relate to each other, especially in a prospective future where capacity becomes a permanent feature. I then showed how the two

arrangements date back to the 1970s debates on EMU, before demonstrating that the recent debates about the reform of the EU's fiscal policy institutional arrangements are essentially variations on the themes offered by the 1970s debates.

I then focused on the political problems that a proper system of coordination (regulation), such as was proposed in 1970 in the Werner report and rediscovered by the Commission in 2016, faces in order to highlight that there is a substantial trade-off between efficiency and input legitimacy involved in the design of such a system. In particular, an efficient coordination system would dealign the level of decision-making and the level of policy implementation, in large part because it is impossible to disentangle the various policy functions that fiscal policy instruments are tasked with. Such a dealignment is a feature of unitary states, not federations, and contradicts the basic decentralising prescriptions of fiscal federalism theory (and the EU's own subsidiarity principle). The trade-off disappears, however, if a permanent EU fiscal capacity is chosen as the way forward. This, moreover, renders the parallel persistence of regulation (fiscal rules) unnecessary and solves the politically highly contentious issues of an adequate supply of financial safe assets and moral hazard. Finally, such a solution holds out the promise of deepening and entrenching the politicization of European integration the Eurozone crisis has given rise to and thus to improve the quality of the EU's input legitimacy by further stimulating participation in European Parliament elections and strengthening the "electoral connection" between voters and MEPs.

My claims are strengthened by their congruence with the historical experience of existing federations. Tasking the federal centre with macroeconomic stabilization and granting it capacity to fulfil this policy function is a constant feature of contemporary federations (all of which are also monetary unions). It is also another key prescription of the theory of fiscal federalism. The IMF's comparative federalism analysis (Cottarelli and Guerguil 2015) suggests there exist no historical cases of federal unions in which the issue of interregional stabilization has efficiently

been dealt with by way of a system of fiscal rules and policy coordination – either symmetrically à la Werner or asymmetrically à la SGP. And there are no cases of coordination systems based on hard enforcement mechanisms. Such mechanisms only exist in unitary states. Finally, the political conflicts that the Eurozone crisis brought to the fore (which revolve around the moral hazard problems involved in mutualising fiscal liability *ex-post*) tend to disappear when the centre is endowed with fiscal capacity in order to pursue macroeconomic stabilisation. The EU is also in a good place to deal with the moral hazard dilemmas of fiscal federalism identified by Rodden by properly designing a permanent fiscal capacity based on highly output-sensitive revenue and spending items, automatic stabilizers and conditional investment grants to the member states.

I therefore end this article with a call for scholars to more explicitly address the relative merits involved in the parallel proposals for a permanent fiscal capacity and a reformed coordination system based on the SGP's fiscal rules. My take also suggests political arguments for a way forward. Northern member state public opinions have both been the keenest supporters of strict fiscal rules and a no-bailout commitment ensuring fiscal discipline as well as the fiercest opponents of a permanent EU fiscal capacity. Over the last decade or so, they have registered defeats on both scores. Conceding full defeat on the latter can pave the way for victory on the former.

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[1] "Even in highly decentralized federations, the central budget plays a significant role ... In contrast, institutional constraints on member states in Europe are arguably more overbearing than those in existing federations due, to some extent, to the absence of an economically meaningful center". When comparing the EU to other federal unions in this paper, I base my claims on this IMF study. The study looks at 13 large federations (Argentina, Australia, Austria, Belgium, Brazil, Canada, Germany, India, Mexico, Spain, South Africa, Switzerland and the United States).

[2] William Wallace Oates took part in the group's meetings.

[3] McDougall opposed the single currency in the 1990s, precisely on these grounds (Geiger 1998).

[4] For example, there is no index entry for it in either James (2012) or Marsh (2011).

[5] See for example the conference "Feasibility and Added Value of a European Unemployment Benefits Scheme", organised in July 2016 (https://www.ceps.eu/wp-content/uploads/2016/06/07112016%20EUBS%20conference%20-%20final%20programme.pdf).

[6] The literature highlights two such limits. First, the same member states tasked with enforcing compliance can potentially find themselves on the receiving end of enforcement in the future. They thus have an incentive to be lenient on their offending peer in case they need the favour returned in the future. Second, the ultimate sanction in the system (a fine) will only aggravate the problem that enforcement of the rules is supposed to eliminate. The sanction threat is thus not credible. Unsurprisingly, no fine has ever been imposed since 1997, despite hundreds of breaches of the rules.

[7] The reforms also include the introduction of the Macroeconomic Imbalance Procedure (MIP), designed to counter the accumulation of macroeconomic imbalances. But while this correctly identifies the non-fiscal channels that can lead to asymmetric shocks, the MIP largely monitors developments over which government policy has little influence, in particular wage

setting dynamics. Governments can be asked to introduce reforms rendering national wage setting systems more responsive to external pressures (in particular, collective bargaining decentralisation from the sectoral to the firm level), but they cannot be asked to raise or depress wage levels in the short-term, which they can do for fiscal policy.

[8] As opposed to SGP decisions, where a special legislative procedure excluding the European Parliament applies.

[9] The distinction between input and output legitimacy comes from Fritz Scharpf's work (e.g. 1997). Input legitimacy derives from the way in which decisions are made. It generally refers to the extent to which directly elected legislatures are involved in policy-making. Output legitimacy derives from the welfare-promoting effects of policies. In the EU, input legitimacy is generally seen as deriving from the extent to which the European Parliament is empowered to participate in decision-making, but also from the extent to which European elections reflect a strong "electoral connection". The consensus is that the EP suffers from a weak "electoral connection" (Hix 2008; Hix and Hagemann 2009). Vivien Schmidt (2013) has forcefully insisted on the need to add a third dimension of legitimacy, namely *throughput* legitimacy, reflecting how effective, accountable, transparent and inclusive the decision-making process is.

[10] This may have already happened. In April 2020, when momentum behind the proposal for common borrowing and transfers started building up, the Dutch finance minister, Wopke Hoekstra, suggested that there should be an inquiry into why member states in the South had not built up enough fiscal space prior to the crisis to allow them to stabilize their economies. The outrage this elicited forced him to quickly backtrack.

[11] Systemically, the ESM has become irrelevant. The systemic solution to the problem of backstopping member state debt has come from the ECB, so much so that member states refused to make use of ESM funds in 2020, despite the almost complete elimination of conditionality. The ECB's bond buying programmes since 2015 (PSPP, PEPP and now TPI) render recourse to the ESM unnecessary since the ECB pre-emptively prevents runs on member state debt. And because the ECB buys the bonds on the secondary markets, any pressure that might have come to bear on the ESM to do so itself has been eliminated since Draghi's "Whatever it takes" in 2012.

[12] Rodden argues that in the presence of these two conditions, central governments find it hard to avoid bailing out subfederal units. Investors and credit rating agencies treat the debt of those units as equivalent to the federal debt because they price in the likelihood of a future bailout. His argument's predictions are that prior to the Eurozone crisis, member states should have behaved fiscally prudently because the federal centre was not extending substantial grants to

member states. This would have rendered credible the no bailout commitment in articles 123 and 125, which would have pushed voters and investors to discipline governments. Moreover, in 2010 the no bailout clause should have been enforced. None of this fits the empirical record.

[13] Although these authors establish a link between intergovernmental grants and subfederal fiscal profligacy, they do not distinguish between matching/conditional and unconditional grants and acknowledge that the distinction might be consequential. Indeed, it can be plausibly argued that conditional federal financing of subfederal spending prevents subfederal units from externalising the costs of their own spending, which is the cause of the moral hazard of fiscal federalism such as they identify it. If that should be so, the NGEU blueprint of conditional grants and loans for specific public investment items would also be appropriate for a permanent capacity that would minimise moral hazard.

[14] "Second-order" elections are elections in which voters offer an assessment of the performance of the victors of the "first-order" elections in the electoral cycle instead of voting based on the political and policy consequences that the particular election can have. In the EU's case, this means that voters in European elections use their ballots to send messages of satisfaction or dissatisfaction to member state governments instead of voting based on their preferences for the make-up of the EP itself. As a result, the "electoral connection" – namely the extent to which the election result determines the behaviour of the MEPs – is weak because MEPs know that their chances of re-election do not depend on what they will do in the EP.