THE FISCAL FEDERALISM AND THE GOOD ECONOMIC GOVERNANCE IN EUROPEAN UNION*

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Abstract

The research objectives aim to analyze the advantages and the disadvantages of the fiscal federalism, in order to identify the model of economic governance that will increase the quality and efficiency in public intervention. The fiscal federalism could have an important impact on the economic and political level in EU, but mostly in member states, in order to obtain a better administration and more responsible governance for the resources allocation, income distribution and fiscal consolidation. Fiscal federalism can bring to Romania advantages towards accessing more European funds and achieving budgetary discipline, and the last but not the least for stimulating economic growth**.**

Keywords: *public economics, governace, federalism*

J.E.L. Classification: *H2, H11, H72, H6.*

Introduction

The integration of the new member states from Central and Eastern Europe have changed the whole architecture of the European Union, creating pressure for a deeper economic integration. In the context of the recent financial crisis, the EU member states have faced the difficult decisions of reducing budget deficits, mainly by cutting budget expenses to achieve fiscal consolidation. The National Bank of Romania's governor, Mugur Isărescu has recently emphasized: "the recent international crisis amplified the need for deep reforms of economic governance, both at European and global level". The opinion of the governor of the National Bank of Romania is that "a good economic governance in the EU can be achieved through five main pillars: fiscal discipline, economic surveillance, close coordination, solid legal framework for crisis management, strong institutions and regulations in decisions making process".[2]

The "EU Sustainable Development Strategy" analyzes and underlines that the goal of "good governance" is to promote the convergence of local, regional, national and global levels, in order to enhance their contribution to sustainable development. Five principles underlying the good governance are set out in the White Paper of the European Governance (COM 2001/428), namely: openness, participation, accountability, effectiveness and cohesion. Each principle is important and is the basis of democracy and the rule of law in member states, and they apply to all government levels: European, national, regional and local levels. Community governance principles are particularly important in order to respond to current challenges of the extended European Union.

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[2] Mugur Isărescu, Worhshop on economic governance in UE, organized by NBR, Mediafax news agency, 2013

The governance encompasses a much broader scope and reflects the customs and rules by which a country authority is exercised. This includes the process of selection, monitoring and replacement of the governments, the government's ability to formulate responsibly and to implement effectively sustainable public policies and the level of development of the public institutions that govern economic and social life and their interaction (World Bank, 2012).[3]

The economic and financial crisis has revealed a number of weaknesses in the economic governance of the EU Economic and Monetary Union. The cornerstone is the new set of rules on strengthening EU economic governance. According to the European Commission, the four main components of the „the economic governance", are the following:

1. Stronger preventive action by strengthening the Stability and Growth Pact and deeper fiscal coordination;
2. Corrective measures strengthened by reinforced Stability and Growth Pact;
3. Minimum requirements for the national budgets to be consistent with the minimum standards of quality and covers all levels of government;
4. The prevention and the correction of the macroeconomic imbalances and the stimulation of the competitiveness are essential factors. New "macroeconomic imbalance procedure" broadens the EU economic governance and the surveillance trends include macroeconomic developments.

The Treaty on Stability, Coordination and Governance in the Economic and Monetary Union (known as the "fiscal compact"), which entered into force on 1 January 2013, was an important step towards ensuring good economic governance of the EU. The Treaty specifically states the main objective of strengthening the economic pillar of the Economic and Monetary Union by adopting a set of rules, which aim to foster budgetary discipline through a fiscal compact, strengthen economic policy coordination and improving governance in the Euro zone, thus supporting European Union's objectives for sustainable growth, employment, competitiveness and social cohesion.[4]

1. Defining the concept of fiscal federalism: advantages versus disadvantages

In his "Essay on Fiscal Federalism", Wallace E. Oates considers the fiscal federalism as a form of fiscal decentralization and as a means of improving public sector performance. Federalism focuses on the relationship between the central government and national governments. The classical theory of fiscal federalism is concerned to establish a framework for the various forms of government functions and to create the instruments to perform these functions (Oates, 1999).

Later, Wallace E. Oates (2002) questions the clarity of terminology "fiscal federalism". Thus, Oates (2002) shows that for those who are not economists, the term suggests a rather narrow area of fiscal relations (or purely financial) between different levels of government. Nevertheless, Oates's view on fiscal federalism is that the area of application is much broader than the fiscal one, and focuses on the roles of the different levels of government, and includes both the fiscal and regulatory functions and the purely political governance tools. Therefore, Oates (2002) defines the fiscal federalism as "multi-level governance economy".

It is noteworthy that the multi-level governance has been developed in many theoretical studies of the EU policies and then expanded in the decision making process at EU level. The multi-level governance is the typical model of European governance and the

[3] World Bank, http://info.worldbank.org/governance/wgi/index.asp

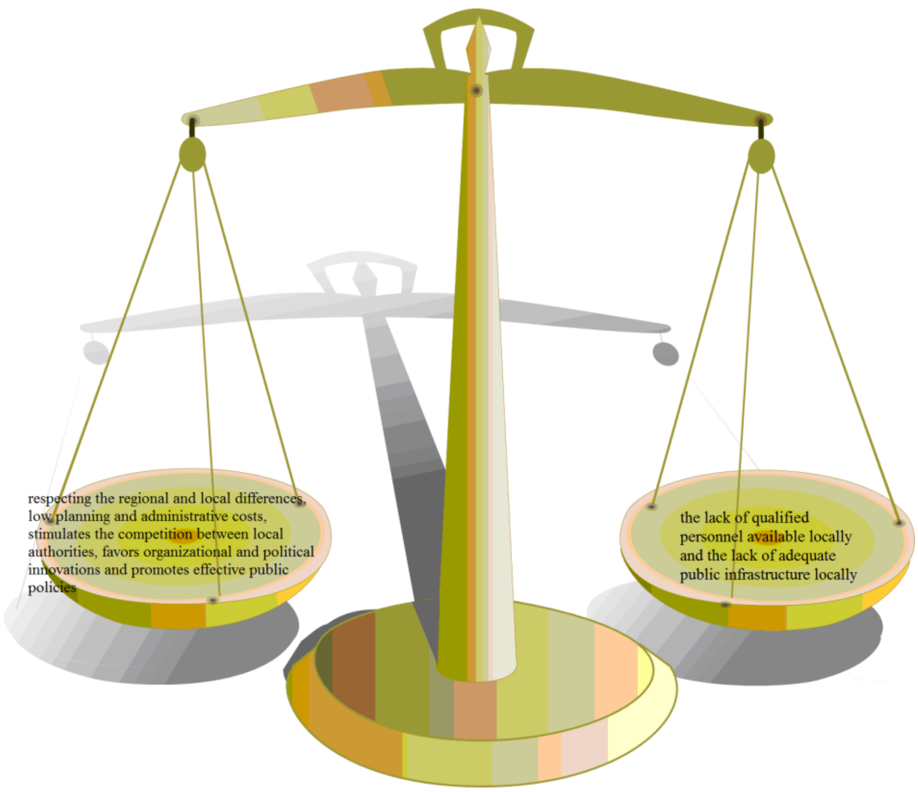
[4] http://www.european-council.europa.eu/home-page/highlights/fiscal-compact-enters-into-force-on-1-january-2013

most appropriate to European realities of contemporary society, considered by many experts. The multi-level governance framework bases on a clear understanding of the role of decision-making process and the complex interactions of all actors in the political governance and focuses on power relations between different levels of government in the EU.

Chanchal Kumar Sharma (2004) distinguishes and clarifies that while the fiscal federalism constitutes a set of guiding principles, a guiding concept that helps in designing financial relations between both national and local levels of the state, on the other hand fiscal decentralization means the application of these principles. Subsequently, Sharma (2011) points out the fiscal federalism complexity and includes in his analysis both the vertical fiscal and the horizontal relations. In his opinion, the areas closely related to horizontal fiscal relations are the regional imbalances and the competition. Similarly, the issues related to vertical fiscal relations show the fiscal imbalance "between the two levels of government, central and local authorities, respectively".

According to the macroeconomics theory, fiscal federalism can be effective in solving the problems that governments face today, such as: income distribution, resource allocation, and economic stability. Due to its flexibility the central government can foster the economic stability and the income distribution, but the allocation of resources should be the responsibility of the local or regional governments. However, as regions and cities are not equal in their income, it is necessary the intervention of central government. The benefits of the fiscal decentralization are the following: respecting the regional and local differences, low planning and administrative costs, stimulation of the competition between local authorities, encouragement of organizational and political innovations and promotion of effective public policies, because the citizens have more influence locally. However, the disadvantages of fiscal federalism are the lack of qualified personnel available locally and the lack of adequate public infrastructure locally (Encyclopedia Britannica).

Figure 1: The advantages versus disadvantages of fiscal federalism



Source: Made by Author after Encyclopedia Britannica

Professor David A. Super (2005) states that relations between the central and local taxes and the public spending programs are becoming increasingly controversial, and the fiscal federalism, a concept designed to divide the regulatory authority between the levels of government, is facing issues of fiscal cooperation. Some financing programs even offer incentives for states to follow the central political leadership, and in other states the central government assumes financial responsibility because of its superior fiscal capacity.

Super (2005) points out that a number of fiscal federalism vulnerabilities are related to either the consistently decrease of the impact of macroeconomic policies of the government to stimulate the economy expansion in periods of recession, or inadequate local funding for the social programs. Consequently, Super (2005) in his article „Rethinking fiscal federalism ", criticizes the recent initiatives of decentralization of the fiscal responsibility for some types of functions such as the finance of the social protection programs. The author asks the countries to update their fiscal rules to eliminate inappropriate solutions to business cycle phases and to equip themselves with appropriate fiscal instruments for carrying out the duties of collecting taxes, for establishing priorities and for allocating resources efficiently.

2. Fiscal Federalism in the European Union

Oates (2002) points out that fiscal federalism explores the assignment of functions to different levels of government, and the design of the tax system and intergovernmental grants. Oates (2002) shows that in the EU, the assignment of the functions takes into account the Member States as modern nation states. However, at EU level it is required a strong central government with expanded monetary, fiscal and regulatory powers. Under these circumstances, Oates notes critically that these developments do not seem to fit very well with some elements of an „emerging confederation ", which represent the European Union.

Oates (2002) relates to Picciotto and Weisner (1998), which showed that in addition to an appropriate division of functions between the different levels of government, providing a high level of performance of the public sector, it is needed the design and the establishment of a set of fiscal institutions and regulators. This can provide the right incentives to implement various types of public decisions. In addition, Oates (2002) accepts McKinnon's idea (1997), that it is necessary to have "precise budgetary constraints" at all levels of government, especially at decentralized level. Furthermore, Oates (2002) criticizes a number of worldwide attempts of fiscal decentralization, which have often been affected by central fiscal institutions, that have provided effective fiscal bailouts for their politicians from the regional and local level.

In short, according to Oates (2002), the fiscal decentralization cannot be achieved simply by allocating funds to the existing or newly formed, regional and local authorities but through appropriate procedures and institutions that should provide fiscal discipline in a way, that encourages effective budgetary decisions.

Sbragia (2004) states that for the review of "the federal characteristics of Union" the researchers focus on the institutions and areas of policy which relate to the former first pillar of the EU, which included: the Common Agricultural Policy, the customs union and the internal market, the competition policy and the state subsidies, the structural policy, the commercial policy, the Economic and Monetary Union, the European citizenship, the education and culture, the research and environment, the trans-European networks, the health, the consumer protection, the social policy, the Common Immigration Policy, the asylum policy, the border protection.

On the other hand, the former second Pillar, which concerned the common foreign and security policy, and the former third Pillar, which covered police and judicial cooperation in criminal matters, showed the characteristics of a confederation based on intergovernmental principles. Therefore, Sbragia (2004) sees the EU as a "semi federal” political entity. In his view, the existence of a common trade on policy and a monetary policy underpin the argument that the development of the European Union may be compared with the type of existing federations and *post Maastricht EU has developed into a species of a federal state*.

According to the views of Boerzel & Hosli (2002), the economic theory of federalism, and more specifically of the fiscal federalism, has been promoted the useful theoretical concepts in order to evaluate the allocation of policy competences at different levels of government, and the final purpose of this approach is to determine a normative-analytical “optimum ". The optimal structure of the public sector concerns the allocation of competences and fiscal powers at different levels of government, effectively. Under these approaches, there seems to be a consensus that the EU macroeconomic stabilization and distribution functions perform better at the central level, but the provision of the public goods is generally more effective at other levels of government.

The approach of the political aspects of federalism is based on the economic reasoning of the efficient allocation of political powers between different levels of government. From the politico-economic analysis, it appears that not only the efficiency considerations, but also by political factors such as electoral dynamics determine the degree of centralization and fiscal decentralization. Moreover, in recent literature, are clear references to compromise between the economic efficiency and the political participation and the last, but not the least, the political representation issues and balancing the territorial and functional interests. Therefore, the most profitable approach is to combine economic with the political reasoning to the study of federalism, which can be helpful to analyze the current system of multi- level governance in the EU (Boerzel & Hosli, 2002).

3. The role of federalism as main instrument of the good governance

Valentin Lazea, chief economist of the National Bank of Romania, believes that fiscal federalism, highlighted by the Treaty on Stability and Coordination in the Economic and Monetary Union, will bring to Romania three advantages: the quasi-free European funds, the monetary discipline and the maximization of the projection of a small economy on global level.[5]

Ferrara (2010) points out that the EU institutional structure influences the behavior of administrators at EU level and that of the national and regional authorities, the costs and benefits of the regulations, respectively the expenses and the revenues of the public service providers. According to Ferrara (2010), the first justification of a need to create an institution links closely to its ability to spend the funds allocated. Secondly, at EU level the cohesion policy is planned multi-annually, but the EU budget is made and approved on an annual basis, given that the funds are assigned for every Member State for each year of the planning period. In case of the existence of the multiple levels of government, it increases the possibility of misallocation, given that both the national government level and the regional level may overestimate their needs only to receive a larger share of European funds. Subsequently, the mismanagement of the funds allocated inefficiently, can subsequently affect the decisions of the EU for the future allocation of funds. This has often led to a situation where some Member States were net beneficiaries of EU funds. Under these circumstances, it is not enough to apply the principles of fiscal federalism and make the best use of the European funds, what it counts more is the quality of the governance of national and local authorities, which have to use the expertise of their employees and other specialists

[5] Valentin Lazea (2012), Declaration from a scientific debate on EU Fiscal Treaty, organized by the Romanian Central Bank.

for evaluating and planning properly the projects funded by EU, and to effectively manage and spend the allocated funds. In this sense, we may say that attracting and management of the EU funds should be based on good multi-level governance at all levels: EU, Member States, regions, local authorities.

Promoting the fiscal federalism as a form of fiscal decentralization can clearly bring benefits in terms of the public policy optimization. A corollary of the theory of fiscal federalism is that decentralization is likely to encourage constantly the efficiency through increased competition between the local authorities (King, 1984). In this regard, many scholars regard the decentralization as a paradigm for complex development and stimulating economic growth.

Many analysts see the decentralization, of any economic and social sector, as an answer to the problems of the centralized systems. Government decentralization, which is the most studied subject, is regarded as a solution to problems such as: the economic decline, the government's inability to fund public services and to the decline in the performance of overloaded services, the weak legitimacy of politicians in face of public opinion and the global pressures on countries with inefficient systems (Holger, 2007). Government decentralization refers to the restructuring or the reorganization of the authority, so that it will prevail a system of co-responsibility between institutions involved in governance at the central, regional and local levels, in accordance with the principle of subsidiarity, thus increasing the overall quality and effectiveness of the governance, while augmenting the authority and capacity of the sub-national levels (UNDP, 1999).

Of all the components of decentralization, the fiscal component has a special significance because the regulation of intergovernmental fiscal relations can find the right balance between the different objectives at each level and may resolve tensions between them (Sharma, 2005). Chanchal Kumar Sharma (2005) notes that fiscal decentralization success depends on the design of the used instruments. These include designing a mix of economic, financial and administrative policies, adequate sequencing and timing, providing a sustained pace of tax reform, balancing contrasting forces of centralization and decentralization. There is no single answer to the complex problems of decentralization and that is why is necessary to consider the specific conditions of each municipality.

Blöchliger & Vammalle (2012) pointed out that fiscal federalism and fiscal reform is a mixture of structural reforms, including fiscal consolidation and reform of the public administration. In their view, the fiscal reform has a number of features:

- Major tax reforms should be made by national governments and local authorities, rather than by interest groups that are outside the public sphere. As a result, the whole economy and society should benefit from the tax reforms, but in reality, the costs and benefits are unevenly distributed, and some individuals and groups may be the main payers, especially on short term.
- It is necessary to evaluate the impact of the fiscal relations reforms, especially on short term. The governments and the administrations are often required to quantify the short-term effects with high accuracy and the winners and losers of these measures, in order to have the exact idea of how the fiscal reforms, intergovernmental grants or tax rules affect certain categories of population and/or companies.
- Fiscal federalism reforms tend to be a “zero sum game” in the short term, if one level of government will lose and the other will win. Asymmetry between winners and losers in the reform process and the uncertainty about the size and distribution of future benefits could weaken the support for fiscal reform.

According to OECD experts, the fiscal consolidation plans have been an important step towards the identification of the areas of savings and reduction of the government spending, but did not go far enough for a number of countries to achieve fiscal sustainability.

Policy makers face a real dilemma when designing and implementing such plans, so while there is broad support for fiscal consolidation, the resistance occurs when proposing specific expenses cuts or revenue increases by tax growth. While health care spends a large portion of the government resources, the reform in this area cannot generate enough savings to balance public budgets. On the other hand, the infrastructure is a relatively small part of the government spending, but many countries are considering this in spending cuts. While protecting the education field from the expenses cuts may be important to ensure the future development of any country, the extended need for fiscal consolidation makes urgently necessary the reductions in some countries.

A strategic approach can help governments to identify when and where is necessary to have fiscal reforms. The "strategic perspective" is the ability to understand and to balance the government values, the social preferences, the current and future costs and benefits, as well as the expertise and the analysis, and to use this knowledge to plan coherently, to define the objectives, to make decisions and to determine priorities. "Strategic perspective" bases on the risk assessment and management, and incorporates decisions based on clear evidence of the policy development and implementation (OECD, 2011b)

Conclusions

The federalism is as a solution to many theorists for institutional innovation, efficiency, freedom, local autonomy, but still allows distortions in subunits (regions), in apparent conflict with the central normative egalitarianism (Follesdal, 2001). The fiscal federalism may affect the intensification of the inequalities in the regional development, due to differences in the tax collection, the fundraising processes and the management of financial resources.

The practical lesson is that a system with several levels of public finances requires a form of vertical transfer from the federal government to the poor regions/states, and a form of horizontal transfer from the rich regions/states to the poor ones (Montana, 2013). In Montani‘s (2013) opinion the European fiscal deficit is one of the characteristics of European democratic deficit and is impossible to escape from the fiscal deficit, without getting rid of the second and vice versa. This means that in order to overcome the European fiscal deficit, is required a political struggle for full political integration of all member states.

In the study entitled "Europe for Growth: For a Radical Change in the EU", Haug, Lamassoure & Verhofstadt (2011), examine the shortcomings of the EU budget and the crucial issue of its size. The authors underline that the EU budget amounts to 1% of the gross national income, which is an amount that has remained modest and stable in the past decade, although the scope of its activities has expanded considerably in the recent years. In the year 2011, it was set at 126.5 billion Euros in payments (141 billion Euros in commitments).

EU could have a bigger federal budget if the European states and their leaders are able to convince people that some public goods (balanced growth, full employment, green economy, security) can be provided by the federal government at a smaller costs, than paying for the same public goods (or the illusion of such public goods) provided by their national governments (Haug, Lamassoure & Verhofstadt, 2011). A fiscal federal system at EU level in the form of fiscal union can reduce the average tax burden of European citizens.

The mentioned above study findings refer to the potential economies of its member states and the EU, which could benefit from simplification of the EU funds procedures, which are currently scattered in different instruments and/or formulas, as well from a greater synergy between the European and national policies and budgets. The authors showed that during the crisis, characterized by a scarcity of the financial resources, there is an urgent need to coordinate the economic recovery of the EU member states and to create incentives for significant investments. These will sustain the economic growth, which is very necessary to meet emerging needs in the EU new member states in order to meet the challenges of the future.

Consequently, "the good economic governance" has two major components: a good management of the existing financial resources at central and local levels, and the promotion of the sustained measures in order to identify the new funding, the new budget revenues, through enhancing the investments, the business environment and the economic growth.

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