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FISCAL SYSTEM AND FISCAL RELATIONS IN THE EUROPEAN UNION: POLITICAL RESTRAINTS AND ALTERNATIVE APPROACH TO PUBLIC FINANCE

Key words: fiscal system, fiscal relations, fiscal federalism, European Union

ABSTRACT

Development of the European integration through the European Union (EU) considers not only strengthening integration from the economic aspect. It also considers the political aspect of the integration i.e. strengthening political integration of member states and their citizens. Political segment of integration considers strengthening of the internal policies of the EU in which fiscal system, i.e. public finances have extremely important role. The EU fiscal system presents reflection of the extremely strong and often confronted interests between the economic and the political integration. These issues are closely related to the second component of this integration, that are the fiscal relations between the EU "central" level and the national "lower" levels which bring the all important decisions in the EU. According to the theory of public finance (fiscal federalism) and the criteria of economic efficiency, fiscal functions (allocation, redistribution, stabilization) are assigned to the different levels of government, as well as certain resources for their financing. On the basis of fiscal functions carried out by national levels in the EU, and the manner of their financing, the EU is a prominently fiscally decentralized complex community. The traditional approach to the fiscal federalism that fiscal authorities are transferred from central to lover levels means that this is a process of decentralization, while in the case of the EU this means centralization of fiscal authorities from the level on national states to the EU as a supra-national level. The main goal of this paper is to analyze fiscal relations in the EU according to basic fiscal functions: allocation, redistribution and stabilization. Methodology would include analysis and comparison of positive EU aspect with normative aspect of public finances in multi-level community. Induction of gained results will confirm thesis that, because of political restraints, development of common (central) system of the EU public finances is based on alternative approaches of harmonization and cooperation.

1. INTRODUCTION

Creating and developing the EU fiscal system is not only an economic, but also an important political process. Generally, the fiscal system rests on the institutions and instruments necessary for the implementation of fiscal policy on a certain area. Creating institutional fiscal infrastructure at a supra-national level of the EU is rather complex and limited due to political complexity of the integration of traditionally independent EU member countries.

The main thesis of this paper is that the EU fiscal system does not develop according to the optimal theory of public finances (fiscal federalism), and different alternative methods are used in order to achieve basic functions of fiscal policy (Musgrave, 1959): allocation, redistribution and stabilization. In order to prove the thesis of this paper, the part following the introduction talks about the influence of politics on EU public finances. The third part gives a survey of the structure of the EU fiscal system, the fourth part talks about fiscal relations and fiscal functions in the EU and the fifth part is the conclusion.

2. THE IMPACT OF POLITICS ON PUBLIC FINANCE IN THE EUROPEAN UNION

The main goal of the European integration is creating common market. The development of the common market lasted number of years; it had several development phases and is now based on the 27 member countries. The existing system of common market didn't have only a basic economic dimension during its evolution, but also the political one which was often vague and extremely complex.

Though the 1957 Rome Treaty anticipated creating an European economic integration, the process of this integration can also be seen as a way to a stronger political integration. The conditions relevant for creating then an economic union did not refer to a political union and it is exactly this segment which today may be the biggest obstacle to a stronger and faster political EU integration.

The system of public finances was always on the border-line between the political and economic aspect of any country and/or integration. In the case of the EU, the fiscal system is a reflection for the level of demarcation between the market integration and a stronger political union. The EU fiscal system has an important role in the finale of EU market integration and enables a necessary cohesion for maintaining the existing level of EU economic and political integration.

Apart from the above mentioned role of the fiscal system, a question about its other functions at the EU level and why it is relevant for a closer studying arises. First, studying the fiscal system is a good instrument for studying the EU political and economic potential, i.e. it can partially give an answer to the question "where is this integration going". Second, but no less important, the fiscal system historically always had an important role in the development of modern states and public society in general, regardless of its predominantly economic component (Šimović, J.& H., 2006).

Because of all these open issues, it is very difficult to define the form and level of the political order and the EU constitutional form from the economic point of view. One thing is definite and that is the fact that the EU has made a step forward in this segment to a semi-developed regional community with some characteristics of an independent state as such (Laffan, 1998: 18-20).

Precisely due mentioned limitations, the EU fiscal system is relatively small and undeveloped compared to the fiscal systems of typical national countries. During the creation of the fiscal system and fiscal relations in the EU, the traditional theory of public finances couldn't be completely used (Musgrave, 1956; Oates, 1972). It was necessary to establish such fiscal relations with which: 1) the EU member countries could keep a high degree of political and constitutional independence, 2) the supra-national or confederal level of government could have only the authorities the member countries gave them, 3) the fiscal rules set at a confederal level wouldn't be in conflict with the ones at the national level and 4) the monetary union should function within the confederation (Mihaljek, 1998:208). In such situation, the possibility for stronger centralization of the basic fiscal functions was weak, especially in the earlier phases of integration.

When studying the EU fiscal system, several things should be kept in mind. First, there is a significant difference in the form and role of public finances in relation to some national EU member countries. Second, public finances and public sector in all developed Western economies form a significant part in the GDP, regardless the historical deviation of the neo-liberal conception of the state in supporting the economic growth and development. The last and maybe the most important point is that the EU fiscal system can't be completely studied and created congruent to the optimal theory of public finances. The main "public" instrument which is at EU's disposal when implementing its policies is regulation, instead of common politics and/or positive integration. Such frame of political intervention limits the development of standard public finances system and includes the theory of public choice in analyzing and creating the EU fiscal system.

3. FISCAL SYSTEM OF THE EUROPEAN UNION

The structure of the EU fiscal system comes down to the EU budget as the only instrument from the central supra-national EU level. The rest of the fiscal system can be seen as a set of different rules and arrangements through which the member states harmonize and coordinate other segments of fiscal policy. This primary refers to harmonization of taxation and coordination of stabilization fiscal policies through Stability and Growth Pact (SGP) and Maastricht convergence criteria.

The EU budget is relatively small and through it a limited amount of funds is allocated compared to the area it covers. According to the size and structure of revenues and expenditures it differentiates from the standard budgets of national countries. The total revenues and total expenditures of the EU budget is little over 1% of the EU's GDP. The EU budget has its own funds resources but these resources come from tax revenues of the national budgets of the member states and are controlled by their governments. The basic function of this budget is to finance common functions and EU policies where the most prominent expenditures are agriculture and the structural policies.

Harmonization of the tax system can be studied as the second segment of the EU fiscal system. Levying tax is exclusively in the domain of the EU member states and tax regulations are part of the national tax system of a certain member country. Still, since the EU membership is based on an international agreement which includes certain rights and commitments for the member states, their tax independence is limited, i.e. divided between the EU and the member states. In order to strengthen the common market, the EU has used directives and other regulations to influence the development of the legal systems of the EU member states and in this way EU used the fiscal harmonization as an alternative approach to fiscal federalism.

The third segment of the EU fiscal system is seen in the coordination of stabilization of budgetary policies through EU's fiscal rules i.e. SGP. The surrounding that influenced the development of the current EU fiscal system also influenced the coordination of budget policies of the EU member countries. In this context, a need for maintaining fiscal discipline inside the monetary union is especially emphasized. The main aim of the SGP is preventing the occurrence of excessive budget deficits, in order to maintain the fiscal discipline, wise public finances management and preserving the economic stability inside the Economic and Monetary union (EMU). The way in which the SGP is implemented is based on a multilateral supervision of the budget positions and on different procedures in the case of excessive deficits[1].

4. FISCAL RELATIONS AND FISCAL FUNCTIONS IN THE EU

The existing structure of the fiscal system formulates the implementation of fiscal policy. Studying Musgrave's (1959) fiscal functions in the EU context one can find many deviations from what the theory of public finances (fiscal federalism) suggests. It is necessary to emphasize once again that the deviations from the theory of public finances should be taken conditionally since creating the EU's fiscal system is happening in conditions of a confederation with many undefined present and future institutional directions of development. According to the theoretical principles of allocation of fiscal functions to different levels of government, the rest of the paper will analyze the role of EU in implementing basic fiscal functions.

4.1. Allocation

The theorem of decentralization dominates the funds allocation segment in the theory of fiscal federalism, i.e. the opinion that the local public goods should be offered locally and common public goods at a central level. If this wouldn't happen, there would be a fall of prosperity at a local level (Oates, 1972) and there would be a possibility that the local population should express its preferences by migration (voting by feet) to the area which best meets their preferences (Tiebout, 1956).

In the EU context common or "supra-national" public goods should be realized at the EU level, according to the theorem of decentralization. Defence and foreign policy are a typical example of such public goods and services. The theorem of decentralization is in accordance with the principle of subsidiarity which claims that the activities of the "central" government are not necessary if the activities of member states don't lead to inter-state extern effects (spillovers). According to this, the intervention at the EU level is necessary only in the case of inter-border extern effects (Cullis & Jones, 1998:303).

[1] On each of these segments of the EU fiscal system see Šimović, J. & Šimović, H. (2006).

Though defence and foreign policy are typical examples of supra-national public goods, there is a significant disinclination of the member states to transferring these functions to the EU. Reason for that is the fear that the common policy of defence and foreign policy could be contradictory to the aims of several members. The other reason is the lack of coordination between member states. In other words, if all the member countries should agree on certain issues, maybe the common policy couldn't be introduced due to the problem of the "free ride". This could mean that certain countries wouldn't like to express their real preferences for e.g. certain foreign policy issues.[2]

There are policies where the central EU institutions have great power for making decisions. These are policies formulated by the Rome Treaty which affect the competitiveness of economies and the biggest such joint policy refers to agriculture which is financed from the EU budget.

The EU budget is relatively small and through it a limited amount of funds is allocated comparing to the area it covers. The size of EU budget is around 1% of the EU GDP (E. Commission, 2006). Comparing it to the USA whose total revenues make around 17,7 % GDP, while this number in the European countries varies from 35-50% (f.e. Germany 36,2%, Sweden 50,6%) (OECD, 2003). The similar happens with the budget's total expenditures. For example, in the USA the budget expenditures are around 18% while this number in the European countries varies from 30-45% (e.g. Germany 32,5%, Sweden 38,8%) (IMF, 2004). If the central EU government should take responsibility for the standard policies and public services which the theory suggests than the EU budget should be increased.

Though relatively small, the EU budget is not irrelevant. The revenue and the expenditure side differentiate from the "classical" national budgets. The EU budget has its own fund resources, but these resources come from tax revenues of members budgets and are controlled by their governments. The EU budget doesn't have standard tax revenues; it actually doesn't have a common tax which would enable a stronger control, higher degree of responsibility and a possibility of financing larger offer (allocation) of public goods and services.

As previously mentioned, the basic public goods and services which are financed trough national budgets are defence, foreign policy, health services, etc. while the EU budget has two significant expenditures: the agriculture (in the subsection Preservation and Management of Natural Resources) and expenditures for a Sustainable Growth (structural funds). Their functional significance is bigger than the budget itself. The EU budget in the year 2005 was 115,9 billion EUR and these two subsections make around 80 % of all EU budget expenses (E. Commission, 2006).

When concerning transferring certain functions to higher levels of government in the EU, the approach of fiscal federalism is different from the approach of the theory of public choice. Public choice is more than restrained when transferring responsibility for allocating resources to a higher level of government because they think that the problem of a

[2] Indecisiveness of the EU to react to the war and aggression in former Yugoslavia on time is often mentioned as a confirmation of this obstacle (Persson *et al*., 1996:4).

possible failure of the central level will be bigger than if it happened on a local level. There are several explanations why the centralization still exists. One of the explanations is that the voters "rationally ignore" these problems due to insufficient amount of information. The problems with accessibility and the quality of information get bigger with the fact that the system has more levels of government. There are opinions that the EU is interesting to the politicians from the member countries because it increases the expenses of collecting information and distorts the real situation with the expenses for the implemented policies which are necessary for the voters to bring rational decisions at elections (Cullis&Jones, 1998:307-309).

4.2. Redistribution

With redistribution function, the theory advocates its implementation at the central level. The main reason of implementing it at the central level is the problem of mobility of production factor caused by the harmful tax competition, and including a wider tax base by taxing at the central level. In this way the theory gave principles which should be applied when giving roles to certain taxes at different levels of government and also negative effects which could appear in case of non-implementation of redistribution function at the central level[3]. The fiscal federalism studies the redistribution at the local level as a local public good. As long as the redistribution is done efficiently at a lower level of government, it should not be moved to the central level.

The basic question in the context of the EU is how important is the issue of mobility in distribution and how much it effects the budget expenditures of the member states? If the mobility of the population is studied than an aggressive redistribution policy in a certain country could attract people with a lower income and vice versa. The conditions which influence the mobility of people in the EU are rather different. This primarily refers to lack of a common European citizenship, then the existence of language barrier but also the differences in culture, religion and other segments of life which are more prominent in the EU than in, for example, USA. For some authors it is only a matter of time when these barriers will be removed and therefore they suggest that the redistribution policy in the segment of income taxation should be implemented at the central level in the EU (Inman & Rubinfeld, 1991).

Due to many major barriers the population mobility doesn't represent a threat which should demand centralization of redistribution policy at the moment. Still, the mentioned arguments don't influence capital mobility and highly qualified workforce. Different capital tax treatments and an increasing demand for the highly qualified workforce influence the mobility of these factors of production and are causing harmful tax competition. Redistribution policy on the level of member states can hardly stop the capital mobility and mobility of highly qualified workforce. Such redistribution policy is, however, not efficient. Mobility and efficiency influence the suggestions that the redistribution policy should transfer to the EU level with a more significant share.

One of the reasons which could affect strengthening of the central redistribution policy within the EU is the role of insurance which is seen through different financial aids

[3] For criteria according to which certain taxes could be collected at the local level see Musgrave (1983).

(transfers). Such help already partially exists in the EU and is realized through the EU budget. Redistribution funds of the EU budget are realized through structural funds and their basic function is to give financial aid to less developed regions so they could achieve economic and social cohesion. Each of these funds has precise goals to achieve in certain areas such as infrastructure, human factor, agriculture, fisheries, etc. That the redistribution role of the EU budget is limited is obvious from the rule which says that each EU member can collect up to 4% of its GDP of the these transfers. This limitation of the redistribution effects of the EU budget is a result of both political and fiscal power which is still in the competence of the member countries themselves.

The traditional fiscal theory explains the reason why the redistribution function exists with altruistic motives – the unselfish will of the individuals to separate a part of their income for redistribution purpose. In contrast to this the theory of public choice explains different transfers, subsidies and tax benefits on which the redistribution is based as an consequence of better level of organization, lobbying of different interest groups and the complexity of the public sector structure. In the context of the EU budget, the latter is more suitable due to the complexity of the vertical structure and political decision making in "the EU public sector". The EU budget is not relatively big nor is it oriented primarily to achieving the function of "prosperity", therefore its normative redistribution role in its very beginning is limited.

In the segment of tax policy, redistribution policy on the EU level was substituted with an alternative approach – with fiscal harmonization. The aims of fiscal harmonization are the same as of fiscal federalism. Due to many differences between the EU members, tax harmonization especially served as a real solution to achieve common goals of the EU members, i.e. achieving so called four great freedoms: the free movement of goods, services, people and capital.

Apart from strengthening common market, tax harmonization happened exactly because every country in this world is reluctant to give up its tax sovereignty. The harmonization process as a minimum degree of unity in the segment of tax policy gave satisfying results only in the sphere of consumption taxation. Goals for the tax policy in the EU, such as stabilization of tax incomes of the member states and the growth of employment, demanded harmonization of other tax forms, especially profit and personal income tax. Except with consumption taxation (VAT), more significant deviations happen in capital and labour taxation among the EU members. Labour taxation due to reduced workforce mobility in the EU is not such an urgent area for implementing stronger harmonization. But, business and capital taxation are areas where the harmful tax competition is happening which is causing many external effects as the "escape" of the capital into tax acceptable countries. The appearance of tax competition is a consequence of the tax base mobility. The theory of fiscal federalism advocates harmonization of the taxes whose bases are mobile while with immobile tax bases this is not necessary (e.g. immobile properties). For this reason, the EU has devoted more attention to these areas of taxation over the last years and therefore many guidelines and other legal acts are in a process of adoption (e.g. Code of Conduct for Business Taxation) in order to prevent harmful tax competition and a more efficient implementation of fiscal policy at the EU level.

4.3. Stabilization

While with allocation and redistribution function of public finance it is possible in some cases that the theory suggests their implementation at lower lever of government (subsidiarity principle), with stabilization function this is not the case. Primarily because of economic efficiency and internalization of external effects its implementation is recommended to only at the central level.

In the EU context, the most important deviation from the theory of fiscal federalism is in the fact that the stabilization fiscal policy is almost completely implemented from the lower levels i.e. member states. There are several reasons why this is so. First, the EU budget is relatively small to create any significant stabilization effects. Second, no other centralized fiscal instrument exists (automatic stabilizer). Third, the EU members which are also EMU members have a common monetary policy whose primary aim is to maintain the price stability. But the monetary policy measures can't have the same effect on all the EU members, which means that there is a possibility they could act pro-cyclic. Due to proved frequency of differential shocks in the EU and the lack of and/or languid of other stabilization instruments of economic policy, decentralized fiscal policies of the EU member states, and especially EMU, are the most efficient instrument of stabilization policy in the EU (Šimović J.& H., 2006).

The theory of fiscal federalism suggests balanced local budgets and controlled local government borrowing. One of the basic deviations in relation to the theory is that of the EU member states budgets are not balanced. Many authors defend the theoretical claims very firmly and advocate balanced budgets of lower government levels which then prevent the uncontrolled growth of the central budget's deficit. On the other hand, the central government can advocate the rule of a balanced budget at a local level but this also doesn't have to be valid at the central level (Alesina & Perotti, 1996).

The control of borrowing exists and is implemented through SGP is only a framework within which member states can independently conduct their fiscal policy. Some constitutional prohibitions and conducting a differential fiscal policy, like in the USA, doesn't exist. Limitations of borrowing through the SGP were imposed because of maintaining credibility and of fear that uncontrolled deficits and public debt could compromise an efficient conducting of monetary policy at the EU level, or EMU level.

If we go by the subsidiarity principle, than there are several reasons why fiscal function of stabilization should be implemented at the level of the EU member states. In order to partially transfer the function of stabilization to the EU level, it is necessary to build some other instruments such as a much larger EU budget with more functions from the ones it carries out today. The other reason could be found in the lack of automatic stabilizers, f.e. unemployment insurance, at the EU level.

In the context of fiscal federalism and the subsidiarity principle it seems very important not only at which level the fiscal policy is carried out today, but also who makes the decisions on this issue and with which instruments it is carried out. When taking into consideration all the claims mentioned, the fiscal function of stabilization will be the most difficult one to transfer to the EU level. Nevertheless, the past practice proved this, because the segments of redistribution and allocation policy in the fiscal sphere at the EU level are relatively more advanced then the stabilization ones. When observing efficiency, it is for now unnecessary in the present fiscal federalism of the EU to transfer fiscal function to a higher level.

Due to everything so far mentioned the concept of conducting stabilization fiscal policy is different in the EU then for each of the EU states. The EU fiscal position is defined by a number of fiscal positions of the member states. On the other hand, the EU fiscal position is partially regulated by fiscal rules. Such given restrictions are a specific quality of stabilization fiscal policy in the EU and provoke criticism. Though many objections to these limitations have its foundations, the empirical data point to the past success of conducting such stabilization policy. However, in the case of stronger recession shocks, the given EU fiscal position and restrictions formulated by the SGP could have major negative consequences. Since the present institutional restrictions are hardly to be abolished, the policies of the member states should be based on hiving up deficit in case of stronger recession shocks. Due to possible negative consequences, many experts advocate a reform of the existing way of conducting stabilization fiscal policy in the EU. One of the possible directions is deviation from the given limitations, for which a reform of fiscal institutions, such as Social Security is necessary (Eichengreen, 2003). Such policy would lead to further (de)centralization but also to disruption of economic integration, which makes it even less probable. The other option is advocated by a group of authors (e.g. Masson (1996), Barry (2001)) and it suggests higher centralization of fiscal powers in the EU and a progress in direction of formulating such fiscal policy which would act most efficiently on the stabilization of cyclic trends and wouldn't disrupt the achieved degree of economic integration in the EU. This scenario before anything includes strengthening of the role of fiscal rules in the EU through which with a stronger coordination and control of certain budget policies stabilization policy would "centralize" as an alternative to fiscal federalism.

5. CONCLUSION

The theory of public finance gave a more definite shape the "rules of the game" which could lead to optimum level of decision making on intergovernmental fiscal relations. However, theoretical rules were modified in many of its contents in the context of intergovernmental fiscal relations in the EU. The fact that there are efforts to transfer fiscal authorities from a central to a lower level of government in the conditions of fiscal federalism is a sign that this is a decentralization process, while in the case of the EU, like this paper has shown, there are efforts to centralize fiscal authorities from the level of national countries to the EU as a supra-national level. The issue of fiscal federalism in the EU is very actual and its own way specific. The EU is an interstate community still searching its identity. Adopting the EU Constitution is only one of the elements which are necessary to build and which already turned out to be a problem. The EU has to go into direction of a stronger political and economic integration if it wants take over the leading role in the world politics and economy. Strengthening fiscal integration is also one of many important assumptions for a stronger European integration. Fiscal federalism is a good approach through which an efficient system of decisions-making at the central EU level and at the level of each member country can be built. Creation of one such system calls for many modified solutions and alternative approaches to the theory which can be seen through harmonization and coordination of fiscal policies. Still, all the solutions have to be found within the framework which is offered by the theory of public finances, all with an aim of creating a more efficient and righteous fiscal system for all the EU members.

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