



# TOWARDS FISCALIZATION OF THE EUROPEAN UNION?

THE EUROPEAN AND AMERICAN FISCAL  
UNIONS IN A COMPARATIVE HISTORICAL  
PERSPECTIVE

TOMASZ PAWEŁ WOŹNIAKOWSKI

Thesis submitted for assessment with a view to  
obtaining the degree of Doctor of Political and Social Sciences  
of the European University Institute

Florence, 15 March 2018



European University Institute

**Department of Political and Social Sciences**

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Signature and date:

A handwritten signature in black ink, appearing to read 'Tomasz Woźniakowski', with a long horizontal flourish underneath.

31 January 2018





*Rodzicom i Babci*

*dziękuję*





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## ABSTRACT

My original contribution to knowledge is a demonstration that fiscalization, a concept I defined as a process that leads to the emergence of a federal power to tax, is triggered by an internal threat. This dissertation focuses on the economic governance of the European Union (EU) from a comparative historical perspective and shows that the emergence of the federal fiscal union is the result of a sovereign debt crisis at the state level. More specifically, it analyzes the conditions under which a supranational power to tax is likely to emerge by investigating the emergence of the United States (US) fiscal union in the late 18<sup>th</sup> century. I analyze the fiscal history of the early US to demonstrate how the institutional flaws of the Articles of Confederation, mainly the central budget based on contributions from the states, so-called ‘requisitions’, led to a sovereign debt crisis at the state level, which triggered taxpayers’ revolts in 1786/1787. I argue that an endogenous threat, exemplified by this social unrest caused by the heavy taxation that the states imposed to pay off the debt from the War of Independence, constituted such a condition. Consequently, this threat paved the way for the ‘fiscal bargain’, which led to fiscalization of the federal government, i.e. the creation of a fiscal union with the federal power to tax (‘federal fiscal union’) based firmly in the new Constitution of 1789.

I then confronted the US experience with the EU ‘post-crisis’ economic governance through the lens of two instruments of integration: fiscalization and regulation. A comparison can shed a different light on a polity such as the EU. In a classical fiscal union such as the US, the federal government has fiscal capacity, but it does not have the power to regulate the fiscal policies of the states. In the EU, we can observe the reverse situation: the European institutions in the last few years have acquired a good deal of power to regulate national economic policies. For instance, under the European Semester the EU can even impose sanctions on the member states if they fail to take ‘the corrective action’ on the excessive macroeconomic imbalances. Moreover, it was decided not to go forward with the fiscalization process. I argue that this is because a threat emerging from the Euro crisis was not perceived as large enough to trigger a ‘fiscal bargain’. Paradoxically, by not agreeing to give the EU fiscal capacity, so that they could protect their fiscal sovereignty, member states gave up more of this very fiscal sovereignty to the central institutions, than states in classical federations.

**KEY WORDS** Articles of Confederation; budget; comparative federalism; comparative politics; direct taxes; economic governance; EMU; European Union; European Semester; Eurozone; Euro crisis; federalism; fiscalization; fiscal capacity; fiscal regulation; fiscal union; historical institutionalism; lessons for the EU; power to tax; process tracing; Riker; sovereign debt; taxation; threat; US federal power to tax; US history.



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## LIST OF ABBREVIATIONS

<b>AGS</b>	Annual Growth Survey
<b>BoP</b>	Balance of Payment
<b>CAP</b>	Corrective Action Plan
<b>CSR</b>	Country Specific Recommendation
<b>DHRC</b>	Kaminski, J. P. et al. (eds) (1976-), <i>The Documentary History of the Ratification of the Constitution</i> . Madison, Wisconsin.
<b>ECB</b>	European Central Bank
<b>ECJ</b>	European Court of Justice
<b>EDP</b>	Excessive Deficit Procedure
<b>EFSD</b>	European Financial Stability Facility
<b>EFSD</b>	European Financial Stabilisation Mechanism
<b>EIP</b>	Excessive Imbalance Procedure
<b>ESM</b>	European Stability Mechanism
<b>EU</b>	European Union
<b>FC</b>	Fiscal Compact (Treaty on Stability, Coordination and Governance in the Economic and Monetary Union)
<b>GDP</b>	Gross Domestic Product
<b>MFA</b>	Macro-Financial Assistance
<b>MFF</b>	Multiannual Financial Framework
<b>MIP</b>	Macroeconomic Imbalance Procedure
<b>MTO</b>	Mid-term Objective
<b>PAH</b>	Syrett, H. C. (ed.) (2011) <i>The Papers of Alexander Hamilton</i> , Vol. IV-V, Charlottesville: University of Virginia Press.
<b>PGWCS</b>	Abbot, W. W. (ed.) (1995) <i>The Papers of George Washington: Confederation Series</i> , Vol. II-IV, Charlottesville: University of Virginia Press.
<b>PT</b>	Process Tracing

<b>SGP</b>	Stability and Growth Pact
<b>TEESM</b>	Treaty Establishing the European Stability Mechanism
<b>TFEU</b>	Treaty on the Functioning of the European Union
<b>US</b>	United States

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*Sir, if we have national objects to pursue, we must have national revenues.*

Alexander Hamilton<sup>1</sup>

*It is proper here to remark that the authority to lay and collect taxes is the most important of any power that can be granted; it connects with it almost all other powers, or at least will in process of time draw all other after it; it is the great mean of protection, security, and defence, in a good government, and the great engine of oppression and tyranny in a bad one.*

Brutus I<sup>2</sup>

*The fiscal institutions of the EU today remind me of those in the U.S. under the Articles of Confederation*

Thomas J. Sargent<sup>3</sup>

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<sup>1</sup> *New York Ratifying Convention. Remarks* (FRANCIS CHILDS'S VERSION, [20 June 1788]'), PAH: V: 19.

<sup>2</sup> *New York Journal*, 18 October 1787, DHCR XIX (1): 107-108.

<sup>3</sup> *United States then, Europe now*, Nobel Lecture, Stockholm 2012, available at [http://www.tomsargent.com/research/Sargent\\_Sweden\\_final.pdf](http://www.tomsargent.com/research/Sargent_Sweden_final.pdf) (accessed 24 November 2017).





# PART I DESIGN AND THEORY

## 1 The Puzzle, Research Question and Approach

*We know that many confederal arrangements, including the Swiss and the US, have become federal because of internal and external threats. Endogenous threats are now also appearing in relation to the future integration process of the EU.*

Alexander Trechsel<sup>4</sup>

### 1.1 Introduction

The lack of the ability of a federal government to raise revenues from its own sources has been identified as the main factor underpinning the lack of sustainability of a federation (Kincaid 2014: 292-293; Riker 1975: 111). In order to become viable, central governments must therefore at some point become financially independent from the

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<sup>4</sup> 'How to federalize the European Union ... and why bother', in *Journal of European Public Policy* 2005, 12 (3): 415

member states. This lack of sustainability can also be applied to the EU, and indeed can be viewed as its main flaw. While the idea of giving EU institutions the power to tax in order to overcome this weakness has been around for many years (see, e.g., Eichengreen 1991: 25-26), taxing would be difficult to implement because 'it implies a fundamental transfer of sovereignty from the nation-states to European institutions' (De Grauwe 2013: 169).

It was precisely this same reason that, in eighteenth-century US, made very difficult to give the federal government the power to tax. As Ferguson (1961: 290) notes about the struggle for the federal power to tax in the late 1780s: '(n)othing testifies more to the audacity of the founding fathers than their demand that the people relinquish what they had fought Britain to preserve (...)'. The American states needed a trigger to agree on such a 'fundamental transfer of sovereignty'. This dissertation shows that the sovereign debt crisis constituted just such a trigger and activated the causal chain that ultimately led to the federal power to tax. The US can thus be seen as an example of successful fiscalization, a process that I define in the section on conceptualization in Chapter 2.3, whereby the federal tax power was firmly based in the Constitution.

It can be argued that the federal power to tax was one of the most important features of the Constitution of the US. For instance, Alexander Hamilton noticed: 'I have applied these observations thus particularly to the power of taxation, (...) because it is the most important of the authorities proposed to be conferred upon the Union'.<sup>5</sup> Meanwhile, the lack of such a tax power has been identified as one of the main flaws of the EU. For example, Moravcsik claims that '(o)ne institutional weakness is the EU's insignificant fiscal capacity' (2001: 169). In a classical fiscal union such as the US, the federal government has such a fiscal capacity - the power to tax. However, it does not have the power to regulate the fiscal policies of the states. In the EU, we can observe the reverse situation: in the last few years, European institutions have acquired

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<sup>5</sup> *Federalist* 33, PAH IV: 466.

a good deal of power to regulate national fiscal policies, but no fiscal power as such.

It is worth noting that there are relevant similarities between the early US federation and the Euro Area today. Under the Articles of Confederation (1781-1789), the US did not have a fiscal union. Congress had no power to tax; instead, it relied on financial contributions from the states, known as requisitions, and, in fiscal matters, it was governed by the unanimity rule. This system proved to be a failure, because a so-called free-rider problem emerged in which every state expected other states to pay the bills and, as a result, the states did not contribute, as they should have done. Because precisely the same methods are used in this case, such means of financing central institutions through contributions and of governing these institutions by unanimity rule - recognized as EU's 'federalist deficit' (Trechsel 2005) - also represent the problems of the functioning of the EU today. This research places a special emphasis on the possible lessons the EU can learn from adopting a comparative federalism lens.

The importance of the federal power to tax for the viability of a union has been recognized in classical studies of federalism (see, e.g., Riker 1964). Yet, only very recently, as a result of the sovereign debt crisis in the Euro Area, fiscalization of the EU has become politically salient. Nonetheless, the research on how a fiscalization process comes about in federations is rather scarce. Recent studies focus on a 'fiscal union' with the implicit assumption that such a fiscal union implies a large central budget, regardless of the way in which the funds are obtained (contributions vs. own resources). For instance, even though Bordo et al. (2011: 26) conclude their comparative study of five federations with the idea that the economic crisis in all of these countries that they analyzed increased the fiscal capacity of the central government and 'instituted a system of transfers and equalization payments', these authors did not study *how* the federal government acquired such fiscal capacity in the first place. This, I argue, is precisely the problem of the EU - such independent fiscal capacity does not exist, and so the EU cannot fiscally expand in times of crisis. As a result, one of the five lessons that these authors provide for the Euro Area is that the recent Euro-

pean crisis may also lead to an increase of such fiscal capacity and financial transfers. However, they do not specify what they mean by ‘fiscal capacity’ - is it simply a large budget or does it also relate to the *mode* of obtaining revenues?

This dissertation shows that the mode of raising revenues, and not only the size of the budget, may be crucial for the viability of the union. The US case demonstrates that building a federal budget that relies solely on the contributions from the member states and not on the federal power to tax, may lead to destabilizing effects for the union. For this reason, studying the mechanism of the emergence of a fiscal union with an independent federal (supranational) power to tax is more salient now than ever.

This dissertation proceeds as follows: in the next sections I present the puzzle, the research question, an overview of the comparative federalism lens and my contribution to knowledge. Then, in Chapter 2, I present the state of the art, the theoretical and conceptual frameworks of analysis, and the hypothesis. In Chapter 3, I describe my research design – the case selection, the methods and data collection. In Chapter 4, I investigate the fiscal history of the early US and provide empirical evidence for the main argument of this dissertation, which links the emergence of a federal power to tax with a sovereign debt crisis. In addition, I analyze the debates on a federal power to tax during the ratification process in order to show that many arguments in favor of the federal power focused on the economic threat. Chapter 5 is devoted to the analysis of the fiscal governance of the EU and the member states’ arguments concerning EU’s fiscal capacity. In Chapter 6, I set out a comparative analysis of the two polities under investigation in order to contrast their fiscal structures and the main arguments regarding fiscalization. Finally, in Chapter 7, I conclude with some insights for the EU in forging a federal fiscal union taken from the US confederation.

## 1.2 The Puzzle

Every government has two main tools, which can be used to influence macroeconomic conditions – monetary and fiscal policy. In order to function properly these two policies, need to be synchronized to some extent. In 1992 in Maastricht the majority of the member states of the EU decided to pool monetary policy at the European level. However, fiscal policy remained at the level of member states. Five years later, the governments of these states realized that some kind of coordination of fiscal policies, at least regarding public debt and deficit, needed to be introduced. Consequently, the Stability and Growth Pact (SGP) was implemented. Nonetheless, when Germany and France were not punished for breaking the rules of SGP in 2003, it became clear that these rules are subject to political bargains.

Still, no action has been taken to make the rules automatically enforceable. However, when the global financial crisis erupted in 2008, and turned into the sovereign debt crisis of the Euro Area member states, it became apparent that some changes on the EU institutional level need to be introduced in order to prevent it from happening in the future. Nevertheless, member states, in order to guard the core of their competences – fiscal policy, would not agree on pooling any sources of revenues at the EU level. Instead, they have introduced another set of rules regulating fiscal policies of the member states, which are supposed to be more easily enforceable. Surprisingly, by avoiding comparisons with the federations and the ‘F-word’ in general, the innovative institutions, like the Fiscal Compact and the European Semester, in fact give the kind of power to regulate fiscal policies of the member states to the EU institutions, that even the powerful US federal government does not possess (Hallerberg 2006; Fabbrini 2012). It is puzzling that the process of fiscalization has not occurred in the EU so far, and that the member states agreed on a very intrusive system of EU fiscal and economic surveillance, instead. In order to solve this puzzle this disserta-

tion builds on a theory of federalism developed by William Riker, because by introducing a ‘threat hypothesis’ Riker’s theory focuses on the origins of federations, which I will incorporate to analyze the emergence of fiscal unions.<sup>6</sup>

The US, on the other hand, emerged as a result of thirteen colonies’ fighting for independence from the most powerful state in the world at that time: the British Empire. The most important reason that led Americans to take up arms was neither culture nor language, but taxation. In the case of the British colonists in North America, they felt that the taxes, which were being imposed upon them by London without their consent were unjust, and Britain imposed these taxes only because none of the American people were represented in the House of Commons. Therefore, these taxes were unlawful and did not fulfill the criterion of ‘no taxation without representation’. It is puzzling why Americans decided to give their federal government a power to tax already in 1787, only four years after the end of the War of Independence and only six years after the ratification of the Articles of Confederation, in which the Congress did not have any power to tax.

## 1.3 Research Question

The objective of this dissertation is to shed further light on the nature of the European integration process and demonstrate the mechanism of the emergence of fiscalization, a concept I define in Chapter 2.3, for instance in the form of a federal power to

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<sup>6</sup> Indeed, as McKay (1999: 9) notes: ‘Riker provides a coherent framework for the analysis (...) of the origins of unions’.

tax. The focus on the *emergence* of this power is inspired by the conclusion in Rodden's (2006: 281) seminal book on fiscal federalism: 'students of comparative federalism must try harder to understand the conditions under which the wide variety of fiscal and political structures around the world emerge and become stable. (...) As authority continues to shift (...) up to higher level entities like the European Union, the questions addressed by Alexander Hamilton, James Madison, and John Jay are more interesting and crucial than ever.' Hence, this dissertation aims at answering the following research question:

*What are the conditions under which fiscalization of a federal type of polity is likely to emerge?*

This question aims at explaining how the process of fiscalization gets started. What does initially push federal or federal-type polities along towards fiscalization? Why does this process occur in some cases (US) while not in others (EU)? Why does the process of fiscalization take place - under which conditions does this fiscal structure emerge, and if it does not – what factors prevent it from occurring? Answering this question through a comparative federalism lens, a topic I elaborate on in the next section, will allow to shed a further light on the nature of fiscal integration.

## **1.4 Comparative Federalism Lens**

A comparison with the US can shed a different light on a polity such as the EU (Fabbrini 2004). The rationale for such a comparison lies in the fact that both cases are examples of the so-called 'coming together' type of federation, where previously in-



dependent states decide to pool part of their sovereignty to the higher level in order to better protect themselves against common threats (Riker 1964; Stepan 1999, Fabbrini 2015). A number of scholars have already compared the EU with the US from the point of view of federalism (Cappellesti, Seccombe and Weiler 1986; Elazar 2001; S. Fabbrini 2005b; S. Fabbrini 2007; McKay 2011; Nicolaidis and Howse 2001; Schütze 2009; Sbragia 1992; Schütze 2009; Trechsel 2005; Weiler 1986; Woźniakowski 2016). Moreover, in the wake of the Euro Area crisis a number of studies has been conducted in which scholars have looked at US fiscal history in search of potential solutions for the EU (Bordo et al. 2011; S. Fabbrini 2015; S. Fabbrini 2017; Hallerberg 2013; Henning and Kessler 2012; Kingreen 2016; Sargent 2012; Steinbach 2015; Woźniakowski 2017). In comparing these two polities, this dissertation therefore falls within a well-established tradition.<sup>7</sup> Comparing the EU with the US does not imply that one regards the EU as a federation - it only signals, as Burgess (2009: 30) demonstrates, that 'integration' is quite similar to the coming together of state units that were previously independent, just like in the case of the US. This is what, for instance, Kelemen does, when he compares the EU and the US at the same stages of the 'federal' development by showing that in many areas of the 'core state powers' (see also: Genschel and Jachtenfuchs [2013]) the US early republic resembled the modern EU (Kelemen 2013).

Within this literature, comparative federalism deserves considerable attention and in order to better understand the developments of the EU, many scholars (e.g. S. Fabbrini 2005b; Nicolaidis and Howse 2001; Trechsel 2005) have started to examine similar processes occurring in the established federations. Some scholars have tended to focus on the comparison of certain areas of public policies in the US on the one hand and the EU on the other. The areas of focus include monetary policy (McNamara 2002), fiscal policy (Hallerberg 2006; Henning and Kessler 2012), among the other

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<sup>7</sup> See Tortola 2014, for an overview of this literature.

policies (McKay 2005; Mendez and Mendez 2010). Another strand of this literature has tended to focus on the more general, institutional design of the polities of focus (Nikolaidis and Howse 2001; Trechsel 2005; S. Fabbrini 2005a; S. Fabbrini 2017; Bokajło 2007; Lacey 2013). Hence, the re-emergence of the comparative federalism studies in 1990s has had an impact on the analysis of the EU, which has been included as a case study in the comparative federalism literature.

There is a large body of literature on federalism and fiscal federalism (see, for instance, the classical studies of Elazar 1987; Friedrich 1968; Oates 1972; Riker 1964), but there is little research on how fiscal federalism, in the form of the federal power to tax, comes about. In the last two decades, a number of scholars has started to use analytical tools developed in the federalism literature to investigate various aspects of the EU (Ansell and di Palma 2004; Bednar et al. 1996; Bokajło 2007; Burgess 2000; Burgess 2012; Fillipov, Shvetsova and Ordeshook 2003; Glencross and Trechsel 2010; Kelemen 2004; McKay 2001; Menon and Schain 2006; Nikolaidis and Howse 2001; Schmitter 2000; Trechsel 2006). Furthermore, some researchers have also adopted fiscal federalism theory to analyze the financial relations among different levels of government in the EU (Borzel and Hosli 2003; Hallerberg 2006; von Hagen and Eichengreen 1996). Many of them would draw on the classical theorists of the fiscal federalism literature (Musgrave 1959; Oates 1972) and postulate the need for fiscalization ('a fiscal capacity') at the EU level, either to finance redistributive policies (Inman and Rubinfeld 1992; Persson and Tabellini 1996; Scharpf 1999) or to address asymmetric shocks (Sachs and Sala-i-Martin 1991).

At the time of the arguably largest crisis the EU is facing since its creation, more and more analyses, papers and policy recommendations are being produced, which in the search of possible remedies and explanations of the crisis draw from the examples of the federal states (S. Fabbrini 2017; Henning and Kessler 2012; Maduro 2012). However, very few studies have been conducted on how the process of fiscalization

emerges, as I demonstrate in the next chapter. By filling this gap, this dissertation makes an original contribution to knowledge, as I show in the following section.

## 1.5 Contribution

This dissertation sheds light on the mechanism of the emergence of a federal power to tax, making two original contributions to the theoretical and empirical literature. In reference to the former, in Chapter 2.3 it introduces the concept of fiscalization, which defines the emergence of a power to tax on the part of central government, and of a federal 'fiscal union', a concept which is often used, but is rarely defined. For instance, Fuest and Peichl (2012) provide five different elements of a fiscal union - it is sometimes difficult to know which elements or definitions scholars use when they write about a 'fiscal union' or 'fiscal integration' (see e.g. Daniele and Geys 2015). Such a conceptual clarification helps to distinguish two fundamentally different instruments of fiscal integration: fiscalization, employed in the US, as explored in Chapter 4.2, and fiscal regulation, mainly used by the EU, which I investigate in Chapter 5.2.

Concerning the latter, this dissertation develops three main bodies of empirical literature, adding, first, to the historiography of the period. To be sure, the controversy over the federal power to tax during the ratification process of the US Constitution was mentioned briefly in the following: Maier 2010: 179-182 (on Massachusetts), 362-369 (on New York); Einhorn 2006: 162-173 (on the federal convention in Philadelphia), and 173-183 (on ratification in the states); Jensen 2005: 17-36; and Rakove 1996: 193-196. Nevertheless, while federal fiscal policy under both the Articles of

Confederation (Becker 1980; Brown 1993; Dewey 1968; Ferguson 1961) and the US Constitution (Edling and Kaplanoff 2004; Einhorn 2006; Studenski and Krooss 2003) has been well researched, historians have largely overlooked the issue of how the federal power to tax emerged.

Second, by analyzing the Confederation period of the US and the link between the sovereign debt crisis and the emergence of federal tax power, this dissertation adds to the US-EU comparative federalism literature. As Thomas J. Sargent remarked in his Nobel Prize lecture: ‘The fiscal institutions of the EU today remind me of those in the U.S. under the Articles of Confederation’ (2012: 3). However, the US-EU comparative federalism literature has largely overlooked the critical juncture period in the US, from 1776-1789, when the system of financing the US federal government resembled that of the modern EU. Instead, in order to provide lessons on how federal solutions could be used in the Euro Area, this strand of literature has focused on the US federal fiscal policy *after* the Constitution was ratified (Bordo et al. 2011; Henning and Kessler 2012; Gaspar 2015)<sup>8</sup>. This dissertation sets out to fill these gaps in the literature and in doing so, in both empirical chapters, it relies mainly on primary sources.

Finally, by analyzing the official documents issued by the EU member states, as well as those from the debate during the ratification process of the US Constitution, this dissertation adds to the literature on states’ preferences regarding fiscalization (but see Kincaid 2014 for the analysis of the idea of concurrent taxation in *The Federalist*). Consequently, in Chapters 4.3 and 5.3 I list the main arguments regarding fiscalization, which allows for testing the main hypothesis of this study, as described in Chapter 2.4.

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<sup>8</sup> See, however, Steinbach (2015) for an analysis of the pre-Constitution events related to the mutualisation of sovereign debt.

This research allows the reader to learn about the similarities (and the differences) between the pre-Constitution US and the modern EU with regards to their financial arrangements; a comparison of the arguments that were used while debating those arrangements; and finally - the conditions under which central level of government in federal-like polities is likely to get a power to tax. This is important, because of the crucial role of taxes in politics and the fact of how popular a federal type of government around the world is, including its traditional form of a nation state and - more recent - supranational polity, such as the EU.

## 2 Theory

*[T]he USA (...) [has] been built upon a political choice enshrined in a written constitution – a political choice made by elites who became aware of the existential need for a federal union after a realistic reading of the insufficiency of the previous confederal project*

Sergio Fabbrini<sup>9</sup>

In this chapter I will show the state of the art in order to demonstrate how my research is situated within the existing literature. I will then present Riker's theory of threat, the main motive of political leaders in striking a 'federal bargain'. This section will be followed by the presentation of my own concept of fiscalization. I will conclude this chapter with a hypothesis on the origins of fiscalization, which builds on Rikerian 'threat hypothesis', and links it with the concept of fiscalization, in order to show that an economic threat is the main reason of political elites in striking a 'fiscal bargain', as I call it.

### 2.1 State of the Art

A number of scholars (e.g. F. Fabbrini 2013; Ziblatt 2014) have thoroughly analyzed the recent developments in the economic governance of the EU, which was a result of

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<sup>9</sup> *Which European Union?* Cambridge: Cambridge University Press 2015: 281.

the Euro crisis, and some of them also identified the dangers of the chosen model of fiscal oversight at the EU level (e.g. Hinarejos 2013: 1638-1641). However, there is little research which would comprehensively demonstrate how exactly the EU encroached on the fiscal autonomy of its member states. The previous research has focused on either particular legal instruments, like the golden rule (F. Fabbrini 2013), the legal aspects of the new treaties (de Witte 2013), the overall constitutional implications of the new EU economic governance (Tuori and Tuori 2014), the Euro Area governance in light of the theories of monetary integration (Nowak 2015) or the actions of particular institutions, like the European Central Bank (ECB) (Schelkle 2012) or the European Commission (Bauer, Becker and Kern 2013). Moreover, the preferences of the member states regarding fiscalization have not been explored in a systematic way.

I analyze how both the legal mechanisms of the new economic governance of the EU and the actions of its institutions, like the Commission, created a system in which the fiscal and economic autonomy of member states has been limited. In doing so, I do not aim at a comprehensive analysis of the aforementioned institutions or policies – this has been done to a large extent. The scope of this dissertation is limited to demonstrating, and giving concrete evidence to justify its claims, that a *fiscal regulation* process is taking place in the EU. In doing so, the framework of the concept of ‘regulation’ (Genschel and Jachtenfuchs 2013) as opposed to *fiscalization* is used, which allows me for identifying institutions and policies that fall within the definition of these concepts. Significantly, while the former implies that federal-like institutions have an ability to regulate state fiscal policies, the latter entails that a central government has a power to conduct its own fiscal policy. I will show that by avoiding the classical fiscal federalism solutions, i.e. a fiscal union with a large and autonomous federal budget, the EU member states ended up building a system of fiscal regulation of the national budgets. Such a fiscal regulation of the member states is not the case in classical federations, such as the US.

Consequently, this dissertation argues that the new economic governance of the EU has introduced a number of mechanisms, which have a profound impact on the vertical shift of power between the EU institutions and the EU member states. The implications of these new mechanisms are not usually perceived, or understood, by public opinion, as they represent a 'covert integration' of core state powers (Héritier 2013). As a result, the EU institutions, especially the Commission, were given the authority in certain domains of fiscal policy, the very policy that member states of the Euro Area so jealously protected, after they gave up the control over their currencies with the adoption of the euro.

Indeed, scholars, particularly economists, have successfully demonstrated the need for a supranational tax in the Euro Area (see, e.g., Eichengreen 1991: 24-26). What has been neglected, though, is how such power to tax emerges and - consequently - the insights for the EU, and especially for the Euro Area, from the Articles of Confederation period of US history, including ratification process of the Constitution. This dissertation sets out to rectify these gaps in the scholarship and it does so by incorporating the theory of federalism developed by William Riker, the topic I turn to in the following section.

## **2.2 Riker's Theory of Federalism**

It can be argued that federalism and federation are similar concepts, as they both share the same etymological Latin root and come from the word *foedus*, which means 'relationship', 'arrangement'. However, it is important to underline their differences. Whereas federalism is a doctrine or a set of principles that characterize such an arrangement; federation, on the other hand, is a form of the organization of the state,



which follows these principles. It can be said that federation requires federalism, but federalism does not necessarily require the existence of a federation. One can think of polities, such as the EU, which follow only some elements of federalism, but are far from the full-fledged federations, such as the US. Within many definitions of federalism (see, e. g. Duchacek 1970; Elazar 1987; Friedrich 1968) William H. Riker (1975: 101) has stated a very general, but probably the most accurate one:

*Federalism is a political organization in which the activities of government are divided between regional governments and a central government in such a way that each kind of government has some activities in which it makes final decisions.*

Riker was one of the most prominent scholars of federalism, who provided theoretical and empirical contributions to this field of study that are still relevant today. The most acclaimed work on the topic was perhaps his book from 1964 entitled 'Federalism: Origin, Operation, Significance', in which he outlined his theory of the emergence of federations. He held the views expressed in this book, with some small modifications he made a decade later, during his entire scholarly career.

Perhaps the most important contribution of this book was his hypothesis concerning the origins of federations. Riker was interested how - under which conditions - federations emerge. He analyzed, so he claimed, all the cases of successful and failed federations and argued that he was able to demonstrate that in all successful cases the conditions he outlined were present, whereas in the negative cases - they were either not present at all or were present only momentarily. The conditions were the following:

1. *The politicians who offer the bargain desire to expand their territorial control, usually either to meet an external military or diplomatic*

*threat or to prepare for military or diplomatic aggression and aggrandizement. But, though they desire to expand, they are not able to do so by conquest, because of either military incapacity or ideological distaste. Hence, if they are to satisfy the desire to expand, they must offer concessions to the rulers of constituent units, which is the essence of the federal bargain. The predisposition for those who offer the bargain is, then, that federalism is the only feasible means to accomplish a desired expansion without the use of force.*

*2. The politicians who accept the bargain, giving up some independence for the sake of the union, are willing to do so because of some external military-diplomatic threat or opportunity. Either they desire protection from an external threat or they desire to participate in the potential aggression of the federation. And furthermore, the desire for either protection or participation outweighs any desire they may have for independence. The predisposition is the cognizance of the pressing need for the military strength or diplomatic manoeuvrability that comes with a larger and presumably stronger government. (It is not, of course, necessary that their assessment of the military-diplomatic circumstances be objectively correct.) (Riker 1964: 12).*

These two conditions, Riker continued, were always present at the federal bargains. Moreover, both groups of politicians must agree by their free will to this bargain, therefore any use of force is excluded (Riker 1964: 12). The conditions are not sufficient (even though Riker was tempted to make such a claim, but he ‘cannot possibly collect enough information to prove sufficiency’ [Riker 1964: 13]), but necessary ‘predispositions for making any federal constitutions’. Importantly, in order to prove his threat hypothesis, Riker did not have to demonstrate that the perceptions of the

threat were correct - it was enough to show that the political elites had a subjective perception of a threat, which led them to struck a bargain.

A decade later, in 1975, in his eighty-page long article in the 'Handbook of Political Science' entitled 'Federalism', Riker expanded his conditions to include an internal threat. By doing so, he accepted the critique that Birch (1966) expressed in his 'Approaches to the Study of Federalism', in which he examined Riker's two conditions from 1964 and 'expanded these conditions to include the desire to deter internal threats and a willingness to have them deterred' (Riker 1975: 114). Riker consequently called them Riker-Birch conditions and formulated the following test:

*In every successful formed federalism it must be the case that a significant external or internal threat or a significant opportunity for aggression is present, where the threat can be forestalled and the aggression carried out only with a bigger government. This is what brings union at all and is the main feature, the prospective gain, in both giving and accepting the bargain. At the same time there must be some provincial loyalty so that the bargain is necessary, that is, it must be necessary to appease provincial rulers. This is what prevents the formulation of a full-scale national government and thus brings about federation as an alternative. (Riker 1975:116)*

In this test, he reaffirmed his previous threat hypothesis (with the inclusion of the internal threats), but also emphasized the importance of provincial loyalty, which must be present for the federal bargain to take place. Otherwise, there would be no need for the existence of a multi-tier government.

In the article published in 1996 in the volume edited by J.J. Hesse and V. Wright, 'Federalizing Europe? The Costs, Benefits, and Preconditions of Federal Political Systems', Riker reflected on the EU and federalism. He provided a typology of types of government, which differ in the degree of centralization and consequently enumer-

ated the following: the independent governments, the alliance, followed by the federation and finally the empire/unitary government (Riker 1996: 11). Therefore, he regarded the independent governments as the most peripheralized type and the unitary government/empire as the most centralized one (see also Riker 1964: 5-10). According to Riker, the federation is less costly than the empire, because federal integration is peaceful and as such is not conducted through an expensive conquest. The federation must of course have two tiers of government, and the member states (constituent units) must recognize the power and authority of the federal government.

In Riker's view the twentieth century was a century of federalism, as a large number of countries in the world adopted its principles and became federations. He analyzed how the EU could become a federation in light of his necessary condition. Riker noted that in the EU case this primary condition of a military threat is not present, which makes the prospect of the European federation difficult. Still, he recognized a secondary motive that is present in the EU, which can make federalization likely to occur: trade restriction. It was unclear, however, if this secondary motive can substitute military motivation in leading to the creation of EU federation.

Rikerian theories were extensively examined and criticized. I will now assess the main critique concerning his threat hypothesis.<sup>10</sup> Apart from the already-mentioned critique of Birch (1966), another one came from Dikshit (1971, 1975), who challenged Riker's military threat hypothesis based on his case studies of the formation of federal states in Austria and Germany after the Second World War. Dikshit (1971) claimed that the military threat was much less important than Riker maintained. Another critique came few years later from S. Rufus Davis (1978) who, while admitting that a military threat was always present during the formation of alliances, also accused Riker of exaggerating the importance of this factor. Moreover, he claimed that Riker's 'proof' is 'highly argumentative' (Davis 1976: 132-133), and that Riker did not explain

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<sup>10</sup> In reviewing the critique of Riker's threat hypothesis I used Burgess 2012: 99-106.

why his two conditions would lead to a 'viable federal child', rather than 'sickly-confederal or quasi-federal offspring' (Davis 1976: 136-138).

In the following decade Preston King, in the book *Federalism and Federation* from 1982, also focused his criticism on Riker's notion of threat. King claimed that the 'threat criterion remains a trivial one', first of all because 'the risk of threat of conflict is present in all unions whatever' so it would not be difficult to find them also in the 'successful federations'. Secondly, he pointed out that Riker did not specify how 'serious these threats are' and that this is information that the researcher should have before looking for evidence to uncover such threats (King 1982: 34). Alfred Stepan, on the other hand, concentrated his critique on the case selection. Particularly on the fact that Riker mainly analyzed the US and 'elevated the model of the United States to a universal' (Stepan 2001: 19). Stepan went on to enumerate the main flaws of Riker's framework, which originated from this US-centered approach. The first one was the focus on the 'voluntary bargain', as derived from the Philadelphia convention, which was not always the case for other federations, Stepan asserted. Second, the historical circumstances of the federal bargain were very different across analyzed countries. For instance, Stepan showed that not always previously independent units create a federation, but that this form of government also emerged from the previously unitary states, which at some point decided to transform into a federation. Stepan called these two groups of federations 'coming-together' and 'holding-together', respectively (Stepan 1999).

Most recently, David McKay (2004) defended the Rikerian theory of threats. By emphasizing 'the conditions of the Rikerian bargain', which were necessary for the bargain to take place, he dismissed King's critique.<sup>11</sup> These conditions centered on the understanding and perception of a threat by the key politicians, who offered and accepted the bargain. Likewise, Craig Volden (2004) in the same year defended Rikeri-

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<sup>11</sup> See also his adaptation of the military threat for the analysis of European integration in McKay (1997).

an theory. Volden dismissed Riker's critics, because they focused on 'a narrow reading of his military condition' and somehow missed the fact that Riker widened the definition of the threat, while he 'never stepped away from the logic behind his two conditions, nor from the need to focus on the motivations of influential politicians in striking the federal bargain' (Volden 2004: 93).

As both McKay and Volden stressed, the perception of key actors was crucial in understanding the importance of the Rikerian military threat hypothesis. Indeed, Riker 'persistently focused upon both the key politicians who made the decisions and their underlying motives' (Burgess 2012: 103). As Riker himself wrote - he presented 'a social law' and 'embedded the law in a theory about the motivation of politicians in the situations in which federations are formed' (Riker 1987: 70).

Despite the critique that Riker's theory of threats received, his work is still appraised and regarded as one of the most prominent in the comparative federalism literature. As Burgess (2012: 105-106) notices:

*It is clear that this [‘the nature, meaning, and significance of Riker’s federal bargain’] has become a veritable hallmark of his approach to the origins and formation of federal states. And notwithstanding its many critics it is an approach that has endured. (...) we can already appreciate its nature as emerging from a quintessentially rational form of human behavior that springs from both real and perceived interests of key elite political actors. Its meaning derives (...) from the specific context of Rikerian conditions that involve an internal or external military threat coupled with the desire of politicians to expand their territory. Federal state-building is therefore circumstantial; it is historically contingent and has no abiding moral significance.*

Riker maintained, even in his last article on the EU from 1996, his main argument, which was very political - the existence of a military-diplomatic threat as necessary precondition for making a federal constitution - and he did not take into account other, such as social or economic, motives that could lead to the federal bargain.

By analyzing the perceptions of political elites that led to what I call a *fiscal bargain* (the creation of a federal fiscal union, where federal government was given the power to tax), I follow Riker's theory of threats. I do this in Chapters 4.3 and 5.3. In Chapters 4.2 and 5.2, in turn, I outline the economic situation that led to such perceptions, with a focus on the economic depression and fiscal crisis in the states in the mid 1780s in the US, and the Euro crisis in the 2010s in the EU.

This dissertation will follow the main Rikerian claim, but in so doing it will take into account an *economic threat* and consequently will argue that the internal economic threat is a necessary condition for the emergence of fiscalization, a concept I define in the following section.

## 2.3 The Concept of Fiscalization

In conceptualizing the fiscalization process, I build on the definition of federalism developed by William H. Riker, as elaborated in Chapter 2.2. Riker stressed the importance of the ability to make final decisions for each tier of government in at least one policy area. By building on this observation I emphasize the significance of the ability of the federal government to make final decisions in the area of fiscal policy, so it can raise its *own* revenues. Thus, I define the concept of fiscalization as follows:

*Fiscalization is a process through which a certain level of government (supranational/federal/central) expands its power to raise its own sources of revenue, and in so doing it decreases the level of vertical fiscal imbalance.*

The concept of vertical fiscal imbalance (contributions/transfers as a percentage of total revenue) has usually been used to analyze the financial dependence of the member states of the union (i. e. regional governments) *on the central government* (Rodden 2002: 672). Conversely, I use it to show the financial dependence of a central government *on the member states* and the potential consequence of such dependence for the viability of the union. For the purposes of this dissertation, the fiscalization process is limited to the central government - by central I refer to either the federal



(US) or the supranational (EU) levels of government - and, if successful, fiscalization leads to the emergence of a *federal fiscal union*, i.e. a union with the federal power to tax. I have added an adjective 'federal' in order to differentiate such a fiscal union from many other uses of this concept (Fuest and Peichl 2012). Therefore, a central budget that consists of contributions from its constituent units cannot be recognized as part of the fiscalization process, even though its size may be significant. This is a crucial difference between fiscalization and other concepts that are used in the literature, such as 'fiscal capacity', which tends to emphasize only the size of the budget, and not the means of obtaining the revenue. In the concept I propose it is crucial that a government has a power over the source of the revenues, for instance a power to tax. The fiscalization process is also limited to the 'getting money' side of the budget (Riker 1964: 54) and does not concern the spending side.

Importantly, *fiscalization* is fundamentally different from *regulation of fiscal policies of the member states of the union* (in this dissertation also called 'fiscal regulation' for the sake of simplicity): while the former entails that a central government has an ability to raise its own revenues and thus - a power to conduct its own fiscal policy, the latter implies that federal-like institutions have a power to regulate fiscal policies of the member states of the union. Consequently, although both are the instruments of fiscal integration, their scope and potential consequences are fundamentally different, as I show in Chapters 4 and 5. Thus, these two instruments of fiscal integration should not be confused. I hypothesize on the conditions under which the first of these instruments is likely to emerge in the following section.

## 2.4 Hypothesis

In this dissertation the following hypothesis, which is a starting point for a more specific model, will be tested: *If a federation encounters an economic threat, then the process of fiscalization will be launched.*

In order to be more precise, the following model, upon which I elaborate in more detail below, will serve as an analytical basis for this study: *The more severe the economic threat, the higher the likelihood of the fiscalization process occurring.*

*The more severe the economic threat > the more perception that solutions cannot be found at the member state level > the more incentives for the member states to seek solutions at the federal level > the higher likelihood of the adoption of the solution at the federal level > the higher likelihood of the fiscalization process occurring*

In formulating my model, I built on Riker's 'threat hypothesis' - I argue that the mechanism of striking a fiscal bargain resembles the mechanism leading to a federal bargain. Similarly, the two bargains must result in a constitutional-level arrangement, which secures their outcomes. However, while the federal bargain necessarily results as part of the constitution making process; the fiscal bargain may also emerge later on, for instance as a constitutional amendment. The main difference is that while in the federal bargain the main motive driving politicians to forge the bargain is a military threat, in the case of the fiscal bargain - it is an *economic* threat.

The fiscal bargain, just like Rikerian federal bargain as elaborated in Chapter 2.3, can only be struck if the two groups of political leaders - those offering the bargain and those accepting it - are willing to make such an arrangement. Thus, it has to be based on a consent. The outcome of the fiscal bargain would usually be written in the fed-

eral constitution (or another constitutional level legal act).<sup>12</sup> Both groups of politicians need to accept some losses resulting from such a bargain. However, those key political leaders of the constituent units must expect that the fiscal bargain will lead to more gains than losses. Presumably, both groups expect that the bargain will extend their *fiscal* territory (similarly to the territorial extension motive of the federal bargain), that is, they anticipate that together they will collect more revenues, than they would have done separately. In Chapter 4 I show that it was indeed the case in the US, where the federal government, within a decade from the ratification of the Constitution, collected circa 600 % more revenues from the same source (the custom duty) than the states had done separately.

The essential element of my hypothesis is therefore an economic threat, which is the main motive to strike the fiscal bargain. Significantly, it is not necessary that those fears of a threat are justified - it is sufficient that the elites *perceive* some phenomenon as a threat. Hence, both *the actual* and *the perceived* threats may lead to the fiscal bargain. While it would be difficult to provide an exhaustive list of what exactly constitutes an economic threat, we can enumerate some instances that clearly fall within its definition. Namely, it would be any situation, which would inflict economic damage, for instance an economic depression (which may lead to social unrest). I expect to find the evidence for those empirical implications of my economic threat hypothesis. The next step in my hypothesized chain of events leading to the fiscal bargain would be the acknowledgement in the statements of the political elites of such a threat. Then, I expect to find statements on the counter measures that the elites plan to undertake in order to tackle this (whether real or imagined) economic threat. Finally, I expect to find arguments of the key political leaders, linking the threat, however it may be exemplified, with a need for the fiscal bargain. Such a bargain would lead to fiscalization - granting federal-like government the power to tax, which would be used to

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<sup>12</sup> The constitutional arrangement, however, may lack stability as the member states of a federation may want to change the institutional design in order to benefit from redistributive nature of those institutions (see Filippov et al. 2003).

either tackle the current threat or prevent such a threat from causing economic (and political) damage in the future. The empirical evidence of the threat will be therefore, for instance, both the actual economic crisis (and its perception among the elites) and the fears of the future economic crisis emerging in the union. The methods by the use of which I attempt to find this evidence are the subject of the following chapter.



# 3 Research Design

*Comparing the integration of core state powers in the EU with that in federal policies does not imply any sort of theology. Asking what can we learn about the EU through this comparison does not require us to assume that the EU is destined to pursue a path of deeper integration*

R. Daniel Kelemen<sup>13</sup>

In this chapter I will discuss my case selection in order to demonstrate why it is legitimate to compare the fiscal structures of the modern EU with the eighteenth-century US. I will then present my methods, putting a special emphasis on the case study, comparative analysis and process tracing. This section will also include a discussion on the practical aspects of conducting process tracing and its implications for this dissertation. I will conclude by the presentation of data collection, where I will show how I gathered the primary sources, which will be analyzed in the following empirical chapters.

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<sup>13</sup> 'Building the New European State? Federalism, Core State Powers, and European Integration' in Genschel P. and Jachtenfuchs M. (eds) *Beyond the Regulatory Polity? The European Integration of Core State Powers*, Oxford: Oxford University Press 2013: 226.

### 3.1 Case selection

It has been argued that ‘the primary criterion for case selection should be relevance to the research objective of the study’ (George and Bennett 2005: 83). The main research objective of this dissertation is theory testing. Given this objective, it is important to note that the case selection was made within the ‘coming-together’ types of federation, as identified by Stepan (1999). It is important because the research question of this dissertation concerns the emergence of federal fiscal powers, in a situation in which, previously, the full fiscal power was vested in the hands of the member states.

In the coming-together federations, the member states decide to pool some of their fiscal power to the federal level. A reverse situation happens in the case of the ‘holding-together’ types of federation, in which previously centralized states (like Spain or Belgium for instance) at some point decide that federalization is needed to accommodate the diverse needs of different regions, so the country can ‘hold’ together. In focusing only on the coming-together type of federal or quasi-federal polities, I follow the advice of George and Bennett (2005: 83), who argue that in some types of comparative study ‘all the cases must be the instance of the same subclass’. Nearly two decades ago Stepan argued that the member states experiencing ‘a prolonged recession’ and ‘very high unemployment rates’, may dismantle some ‘economic federal structures’ of the EU, which are perceived as ‘politically dysfunctional’. Some of them may even choose to leave. One of the main differences between the EU and federations, Stepan noticed (1999: 33),<sup>14</sup> is ‘freedom of exit’:

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<sup>14</sup> In the light of Brexit, ‘predicted’ could perhaps be a better word to describe his observation.

*The fact that since the French Revolution no fully independent nation-states have come together to pool their sovereignty in a new and more powerful polity constructed in the form of a federation would seem to have implications for the future evolution of the European Union. The European Union is composed of independent states, most of which are nation-states. These states are indeed increasingly becoming 'functionally federal.' Were there to be a prolonged recession (or a depression), however, and were some EU member states to experience very high unemployment rates in comparison to others, member states could vote to dismantle some of the economic federal structures of the federation that were perceived as being 'politically dysfunctional.' Unlike most classic federations, such as the United States, the European Union will most likely continue to be marked by the presumption of freedom of exit.*

The comparison between the EU and the US is a well-established tradition in the comparative federalism field, and is sometimes labeled 'the lessons for Europe' type of research.<sup>15</sup> As Burgess puts it: 'federalism in the context of the EU is the application of federal principles to the process of European integration where the term integration refers to the sense of a coming together of previously separate or independent parts to form a new whole' (2009: 30).

One of the most common critiques to this kind of comparison is that federations, such as the US, are much more centralized than the EU, to such a degree that this difference 'amounts to a difference in kind'.<sup>16</sup> Those are justifiable critiques and should not be dismissed too quickly. They refer, however, to the comparisons made

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<sup>15</sup> Sometimes scholars also draw lesson *from* the EU for the US - see for instance Kelemen (2014).

<sup>16</sup> For instance, Moravcsik (2001: 186): 'I have argued that the EU is an exceptionally weak federation. So weak, indeed, that the difference in degree between it and national federations amounts to a difference in kind. The EU's narrow substantive range, modest budgetary resources, lack of coercive force, minuscule bureaucracy, constraining decision-rules within a multi-level system, and far more powerful competitors mean that it might well be thought of something qualitatively different from existing federal systems.'



between the modern US and the modern EU and in such a case they are valid to a large extent.

In order to counter these critiques, one could compare the two polities at the same time of the development since their creation. Many scholars have already followed this path of inquiry and compared the antebellum US (the pre-Civil War period) to the EU (Glencross 2009; Henning and Kessler 2012). As Kelemen (2013: 213) puts it when he argues for comparing the US with the EU at the same time of their ‘federal’ development:

*One challenge in comparing the EU to federal polities is that one must determine not only which federal systems potentially offer the most relevant comparisons, but from which point in time one should draw the comparisons. In other words, should we compare the allocation of core state powers in the EU with that in the US (...) today? Or should we compare the EU with the early years of those federations? During the early development of any coming-together federal system one should expect the federal center to play a relatively limited role in core state powers. Where the federation brings together previously independent states—each of which had previously exercised its own ‘core state powers’—it is unlikely that the states will transfer these powers wholesale to the federal center overnight, but only gradually and grudgingly. Therefore, any comparison of the integration of core state powers in the EU with that in coming-together federalisms should be based on a long-term, historical perspective, and we should recognize that the EU is only in its sixth decade of integration, whereas the US federal system was founded in 1789 (...).*

My aim is to follow this advice and to compare the two polities when their fiscal structures were similar, as acknowledged by Sargent (2012).

Notwithstanding this rationale, there are many differences between the US in the 1780s and the EU in the 2010s, which have to be mentioned. On the one hand, fiscal

discipline, banking crisis and monetary union, were all present in the EU, but not in the US. On the other, in the US there was a common cause of the debt of the states - the War of Independence, while it is not the case in the EU, where debt resulted due to the policies of individual countries (Steinbach 2015).

In Chapter 4 devoted to the US case, I first analyze the fiscal situation of both the states and the union. In the second part, I examine the arguments concerning federal power to tax that were used during the ratification process of the US Constitution. I do so, because for my argument it is important how the threat was perceived by the political elites. The Constitution was ratified in all thirteen states and this process was accompanied by a vigorous debate, with a large number of pamphlets, newspaper articles, letters etc., in addition to the debates during the ratification conventions that were held in every state. It would be beyond the ability of a single researcher in the timeframe of the doctoral studies to analyze the debates in all thirteen states<sup>17</sup>. For this reason, I decided to focus on the most important state - New York.

There are a number of reasons why I decided to focus on the ratification debates in New York State. First of all, it was the only state that did not agree on the impost during the Confederation period and then ratified the Constitution with virtually unlimited power to tax (and custom duties reserved exclusively for the federal government), when the future of the Constitution was still uncertain (Rhode Island finally also ratified the Constitution, but it did so as a very last state, in May 1790, when the new Congress was already in session). New York was the only state that in 1783 vetoed a proposal for the impost. This was one of the two proposals during the Confederation era; the previous one was vetoed by Rhode Island, which refused to even send its delegates to Philadelphia. This is why New York is a special case: the arguments used in this state are likely to be the most comprehensive and persuasive,

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<sup>17</sup> In the still ongoing project of documentation of the ratification process twenty-nine volumes, approximately 600 pages each, have been published as of December 2017 (*The Documentary History of the Ratification of the Constitution* edited by John P. Kaminski et al, <http://www.wisconsinhistory.org/whspress/series.asp>).

since Federalists had to convince the delegates of the state most opposed to the idea of a federal tax.

Second, in the election for the ratification convention, the Anti-Federalists won 46 seats while the Federalists secured only 19 seats.<sup>18</sup> What is more, the victory of the proponents of the Constitution at New York's ratification convention came only by a thin majority of three votes. The arguments used by Alexander Hamilton and the other Federalists had to be quite strong, therefore, if they managed to convince enough Anti-Federalists to secure the ratification.

Third, New York was the last of the four largest states (in addition to Virginia, Massachusetts and Pennsylvania) and the eleventh state to ratify. As a result, the most important arguments used in other states were likely to be also used in New York, also due to the wide circulation of the American newspapers. Fourth, New York was a state where the collection of the most important writings from the ratification battle was produced - *The Federalist*, and one of its three authors, Alexander Hamilton, was the main advocate of the federal tax power. He was the first man to execute this power, when he became the Secretary of the Treasury during Washington's presidency. Finally, New York was a state that derived more than a half of its revenues from the tariff (Edling and Kaplanoff 2004: 720), and under the new federal power to tax, this source of income would have to be given up. Still, New Yorkers decided to ratify the Constitution, which transferred the right to impose tariff to the new federal government.

The EU case is different than the US, as the emergence of a fiscal capacity did not happen so far, and maybe never will. Nevertheless, the dynamics of the current crisis of the Euro Area, which constitutes an internal economic threat, may change this. Based on my theoretical argument, the process of fiscalization will be launched if the crisis continues to affect the economy and to threaten the EU. Although the fiscaliza-

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<sup>18</sup> Maier, *Ratification*, 341.

tion did not happen, the EU decided to implement a stringent regulation of the national fiscal policies instead and to launch a debate on the future of the EU, where the idea of fiscalization (or, in the EU jargon, ‘fiscal capacity’) plays an important role. Consequently, in Chapter 5, I analyze the regulation of fiscal policies of the EU member states, as well as the debates concerning fiscalization in order to test my ‘threat’ hypothesis. In the next section I outline the methods used to achieve that goal.

## 3.2 Methods

In order to answer such a complex research question as outlined in Chapter 1.3 (‘What are the conditions under which fiscalization is likely to emerge?’), it is most appropriate to conduct case studies rather than large N studies. It is because such a question requires an in-depth investigation of the conditions that precede the emergence of fiscalization, and so only a historical study can be employed to discover the most important conditions. Comparison, on the other hand, can shed a further light on a polity such as the EU. It enables the researcher to see all the differences, as mentioned in Chapter 3.1, but also the similarities of the instruments of fiscal integration. The method employed in this dissertation will be therefore a focused, structured comparison (George 1979; George and Bennett 2005). I will conduct a theory-guided historical analysis, with historical institutionalism being my main methodological approach (Steinmo, Thelen and Longstreth 1992; Thelen and Steinmo 1992). Importantly, historical institutionalism, as Steinmo notices (2008: 118):

*(...) is distinguished from other social science approaches by its attention to real-world empirical questions, its historical orientation and its*

*attention to the ways in which institutions structure and shape behavior and outcomes.*

For these reasons - taking history and institutions seriously in order to answer salient, 'real-world empirical questions' - historical institutionalism is the most appropriate approach for the kind of research question I aim to answer.

I use process tracing (PT) (George 1979; George and McKeown 1985; Collier 2011; Bennett and Checkel 2015), a method which by focusing on time allows to 'specify the causal mechanisms that connect causally relevant events within (...) process' (Falleti 2013: 141). PT allows for the analysis of the phenomenon under scrutiny in a temporal dimension, rather than at one particular point in time. This type of inquiry is what Pierson (2004) calls a moving picture, as opposed to a snapshot. In so doing the PT allows for the analysis of not only timing of important (usually causal) events, but also of their sequence - what happened when, which events were first and which came only later. PT also enables the researcher to trace pertinent actors involved in the case (usually in decision-making) - their knowledge and behavior - 'who knows and does what when' (Bennett and George 1997: 18).

This feature of PT has profound implications for the type of data the researcher uses for her work. A useful distinction has been made between the data set observations and the causal process observations (Brady and Collier 2010: 184-196). PT employs mainly the latter category and can be seen as a collection of 'empirical material in order to detect the potential observable manifestations of underlying causal mechanisms' (Beach and Pedersen 2011: 20).

PT can be conducted through both induction and deduction - depending on how much is known about the case and how well the theories that could help explain such case, are developed. If the case, or the phenomenon we seek to explain, is not very well known, first of all we need to inductively collect lots of information, in a procedure sometimes referred to as a 'soaking and poking', without knowing if the

collected data will be part of our hypothesized explanation. The same procedure needs to be followed if the phenomenon is ‘not well explained by extant theories’ (Bennett and Checkel 2015: 22). I discuss the procedures of PT in detail in the following section.

### *3.2.1 Process tracing in practice*

Bennett and Checkel (2015) provide a very valuable list of ‘best practices’ of PT. This is a rare example of the concrete advice on how to use this method. Most of the work on PT focuses on its philosophical and methodological advantages and the superiority over the other methods. Admittedly, sometimes these accounts do describe ‘how to’ do PT, but usually the advice they give is on a quite high level of abstraction, and therefore its usefulness is suboptimal. Furthermore, it seems that some of the types of PT exist only in theory. For instance, Beach and Pedersen (2011) fail to provide even one single example of the ‘theory-building’ type of PT (they identify also ‘theory-testing’, and ‘explaining outcome’ types) - as they put it ‘this inductive, the theory-building variant of process tracing is surprisingly neglected, with to our knowledge no attempts having been made to show how it actually is done in practice’ (Beach and Pedersen 2011: 16).

I elaborate on those ‘best practices’ of PT - as identified by Bennett and Checkel (2015) - below.<sup>19</sup>

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<sup>19</sup> I am grateful to Jeffrey Checkel for a valuable discussion on some of these practices.

### **1) 'Cast the net widely for alternative explanations'**

The researcher should look for the alternative explanations in different sources. These explanations may originate from, first of all, an existing theory, which is the most common step for social scientists. But the researcher cannot stop here as the theories may or may not fit the particular phenomena under investigation. Historians and the experts of the region (or the studied topic) are the second source of the 'alternative explanations', as they can provide more context-specific account, both when it comes to the specificity of the region/topic and the pertinent historical period. The third source of potential explanations are the 'implicit theories' of the journalists, who follow the development of our case. This kind of source may be equally important for the 'modern' cases about which one can read in the newspapers, as well as for the more 'historical' studies. For the latter, the researcher would have to go to the archives and read the newspapers from that period, in order to extract these 'implicit' theories of the journalist. Additionally, one may find information that is not present in the official documentation or in the diaries of the actors participating in the phenomena under investigation. This leads us to the fourth source of potentially valuable explanations, that is - the perception of the actors involved in our case, especially decision makers. What they were thinking about their actions? Why they were taking this particular decision and not another one? Finally, we should check whether any major theories of social science would fit our case. For instance, we could check both the agent-based and structural explanations. The former includes 'rational calculations, material interests, cognitive biases, emotional drives, or normative concerns' (Bennett and Checkel 2015: 30), while structural explanation may be institutional, material or normative.

By helping to uncover causal mechanisms, these potential alternative explanations may be very useful for the analysis. In Chapter 4, for instance, I will analyze primary sources, such as letters and pamphlets in order to identify if a threat - the main factor of my hypothesis - was a driving force leading the decision makers to give the feder-

al government the fiscal power. Secondly, I will analyze secondary sources - books and articles written by historians and examine if they have any theory, even implicit, on why this happened. Thirdly, I will examine the accounts of contemporary actors involved in decision-making - what the Framers were thinking about the possibility of granting new government the 'power of the purse'? What kind of arguments did they use?

## **2.) 'Be equally tough on the alternative explanations'**

The researcher should consider all the possible explanations and have to be careful not to fall into the trap of the confirmation bias. Cognitive science teaches us that we have a natural tendency to select and highlight the evidence that confirm our explanation and downplay the evidence that confirm rival hypotheses. The way to counter this is to outline predictions of the few explanations we found and then confront each prediction with the evidence gathered. However, it seems that it would not be feasible to explore all of the alternative explanations in a single study.

## **3.) 'Consider the potential biases of evidentiary sources'**

While assessing the evidence and its credibility, the researcher must take into account the motives of the actors who produced this evidence. Bennett and Checkel suggest that in order to assess the instrumental motives actors could have, the researcher should apply a two-step Bayesian analysis. In the first step, the so-called Bayesian priors should be connected with the actors' motives. The evidence produced by them is then judged in the light of these priors (or instrumental motives). In the second step, those priors should be modified, based on the evidence produced in the first place. Such a procedure may seem complicated, but in fact it is not. This kind of analysis we do every day, for instance when judging advice people give us. We



presume that they have certain motives, based on our knowledge, but, after interacting with them, we modify our expectations - we change what we think about other people, and the interests they may have.

Obviously, when assessing reliability and validity of the sources, we also take into account the type of source. Consequently, we give a different weight to the official statements and private letters, or private conversations that were secretly recorded and leaked to the public. All of these principles apply to primary sources, it is called *source criticism*, to use the language of historians. However, political scientists often rely on secondary sources, and sometimes only on them (see Bartolini [2005], also Collier [2007] praises the use of secondary sources). It is not surprising, because the role of political scientists is usually different than the role of historians. The latter seek to discover new sources or analyze the existing ones in a new light, and tend to focus on a narrow time period. Moreover, historians try to explain a particular phenomenon in its uniqueness. Political scientists, on the other hand, usually strive to produce a theory, which would be useful in explaining more than just one case. They look for commonalities, try to go beyond uniqueness of the case, and create a framework (and sometimes - a typology) often by using a comparative method. Usually, their task is not so much to find new facts or new sources (of course it is an advantage if they do), but to look from a wider perspective and search for regularities in different cases. Usually, the ultimate goal is to test (less often - to generate) a theory that would explain some important political or social phenomena. For this reason, political scientists often rely on the work of historians, but in doing so they should be careful. Historians are not immune to confirmation bias and a good way to guard against this is to consult a variety of historical work, preferably belonging to different schools. In this dissertation, I use both primary and secondary sources, and when I rely on the latter, I consult a number of studies on a given topic or time period.

#### **4.) 'Take into account whether the case is most or least likely for alternative explanations'**

The decision concerning the case selection will have serious consequences on the assessment if a theory we are using is correct or not. If the theory succeeds in the least likely case, then we have a strong case that it is valid. If the theory fails in the most likely case, we should perhaps find an alternative explanation. In this dissertation, I focused on the case least likely, for reasons explained in Chapter 3.1, to accept federal power to tax – New York State. Therefore, if I find the evidence confirming my threat hypothesis in New York State, it will strongly support both internal and external validity of my hypothesis.

#### **5.) 'Make a justifiable decision on when to start'**

The researcher who chooses to investigate a phenomenon across time, and this is a condition *sine qua non* for PT, needs to make a justifiable decision on when to start her analysis of 'evidence on alternative explanations' (Bennett and Checkel 2015: 34). This decision depends on the puzzle or research question that drives the researcher and, while there are no universal rules, it is suggested that a good way is to start with a critical juncture. Thus, with a period in which 'institution or practice was contingent or open to alternative paths, and actors or exogenous events determined which path it would take' (Bennett and Checkel 2015: 34). Institutions are often locked in this chosen path, due to the increasing returns, externalities etc., as the path dependency theories demonstrate (Pierson 2004). In this dissertation, I start my analysis by focusing on such critical junctures in both the US and EU - the sovereign debt crisis of the states in 1780s and 2010s, respectively.

Bennett and Checkel also introduce the concept of 'potential critical juncture', i.e. a period before or after the actual juncture that led to the outcome we are interested in.

A potential juncture is a situation in which there is a possibility for a change, but for some reason it is not realized. It may be helpful to analyze the evidence concerning potential junctures, because it may shed a new light on the most crucial factors in the actual juncture. If we could detect a number of factors in both the potential and the actual juncture, and the only difference between the two would be just one factor, then clearly we would need to pay particular attention to such a factor, as it may have a strong explanatory power. In this dissertation, I analyzed the actual critical juncture in Chapter 4, and in Chapter 5 I explored a potential critical juncture, which could have led to fiscalization, but it did not, for reasons I tried to uncover.

**6.) 'Be relentless in gathering diverse and relevant evidence, but make a justifiable decision on when to stop'**

The researcher should devote a lot of effort and time to gather diverse and relevant sources. This could serve as a safeguard against a selection bias and unjustifiable conclusions. Consequently, diversity counters cherry picking, that is - selecting only the sources that confirm our theory. What can be added here is that selection of evidence is one thing and its analysis is quite another. The evidence is not always straightforward and rarely 'speaks for itself'. Quite to the contrary - often from particular evidence different conclusions can be drawn. Thus, a careful analysis (or critique, to use the language of historians) of primary sources is equally crucial.

The selection of diverse evidence can protect against error, but here again - they have to come from different agents, which do not share the interest of convincing the reader of the validity of a particular interpretation. On the other hand, the relevance of evidence gives the researcher the confidence that she uses the right sources to answer her question.

Finally, the researcher needs to decide on when to stop collecting data. Bennett and Checkel advise to stop gathering evidence, when repetition occurs, and the new sources start to have little added value. If the stream of evidence (new diaries, another governmental report or additional set of statistical data) do not add anything new to the existing knowledge, or add very little so the effort of collecting them is not justifiable, we should stop. However, there will always be a trade-off between stopping too early and hence risking the omission of some important information and stopping so late, that the time and energy of the researcher is basically wasted, due to the limited amount of additional information gained from the new sources.

In this dissertation, in Chapter 4 for instance, I decided to stop at the moment of the ratification of the US Constitution, which took place in 1788, as I focused the fiscal situation of the US under the Articles of Confederation on the one hand, and the debates during the ratification process, on the other. Moreover, I stopped collecting the primary sources when the repetition started to occur and the new evidence started to have a little added value. When it comes to the EU case, and taking into account the dynamic nature of its fiscal governance structure, I decided to stop collecting the evidence at the time of writing (July 2017) in order to analyze the most up-to-date evidence.

## **7.) 'Combine process tracing with case comparisons when useful for the research goal and feasible'**

Comparative case studies may strengthen our inference. PT can be a useful tool in confirming that the explanatory variable we analyze is in fact the main cause of the outcome of interest. PT can also help in identifying the relevant cases, due to the possibility of finding omitted variables that can lead to a better case selection. By comparing the EU with the US, I follow this advice.

## 8.) 'Be open to inductive insights'

PT allows for discovering 'many potential causal factors, evident in the details and sequences of events within a case' (Bennett and Checkel 2015: 39), that do not fit a given theory or hypothesis. If such a causal factor (as shown in the new evidence) proves to be true, then we should modify our explanation. What is important is to try to find a theoretical explanation of surprising causal factors and avoid 'just so' type of narrative, i.e. a narrative that is merely descriptive and does not seek to embed the surprising, inductive insights into the theoretical framework. I remain open for the inductive insights, for instance by analyzing and presenting all the evidence that I found and not only those that confirm my hypothesis. This also helps me to avoid 'a cherry picking' type of data collection, as explained in Chapter 3.3.

## 9.) 'Use deduction to ask *if my explanation is true, what will be the specific process leading to the outcome?*'

PT is usually deductive, even if it allows for the inductive 'surprises'. In order to use deduction we need to first operationalize a theory, which by definition is general, in a way that it can be applied to the specific process we are interested in. The theory that I applied in this dissertation predicts that fiscalization comes about as the result of a threat. Admittedly, this is quite general, so I need to narrow it down and specify the observable implications or the specific process leading to the outcome - i.e. the facts and sequences of events that should be true if my explanation/theory is correct. Bennett and Checkel suggest using this technique for each of the alternative explanations but I doubt this is feasible.

Consequently, in Chapter 4 I predict that the actors involved in the Constitution making, should have talked about an internal threat before they took the decision to draft and ratify the Constitution with the federal power to tax. A similar type of evi-

dence, although much weaker as a full-fledged fiscalization process did not take place, I predict to find in the EU case.

#### **10.) ‘Remember that conclusive process tracing is good, but not all good process tracing is conclusive’**

This advice is rather self-evident: not always the evidence the researcher obtains will support only one hypothesis. It is important, therefore, to acknowledge the level of uncertainty and if the alternative explanations are also feasible.

To sum up, while some of the above ‘hints’ may seem to be obvious or self-evident, I still find them useful in guiding my analysis and I tried to follow them, if feasible. Importantly, PT is especially valuable for the kind of historical comparative research that this dissertation employs, not least because of the many features it shares with historical methods. In the next section I demonstrate the usefulness of PT for the research objectives that this dissertation aims to achieve.

### ***3.2.2 A step-by-step approach***

Simplifying greatly, we can distinguish three crucial steps in which the researcher needs to proceed in order to be able to conduct PT.<sup>20</sup> Table 1 below summarizes these steps and demonstrates the examples of their application in this dissertation. In the process of investigation, the researcher should first - in Step 1 - develop a suitable theory (in this dissertation - a theory of internal threats derived from William Riker’s

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<sup>20</sup> I am grateful to David Collier for explaining this to me.

theoretical framework); followed by the relevant hypothesis, constructed in Step 2, in the jargon of PT - ‘expectation’, as predicted by the theory or the inductively gathered data (in this dissertation it is the following: If a federation encounters an economic threat, then the process of fiscalization will be launched). Step 3 consists of enumerating the observable implications, i.e. the theorized evidence that the researcher expects to find, in order to test her hypothesis.

**Table 1. Practical application of the method of Process Tracing**

Steps	General: as recommended by Process Tracing	Specific: as applied in this dissertation
1	Theory	Theory of internal threats derived from William Riker’s theoretical framework
2	Expectation (Hypothesis)	If a federation encounters an economic threat, then the process of fiscalization to be launched
3	Observable Implications	Economic threat in the form of the sovereign debt crisis, the tax rebellions, an economic depression etc. as perceived by the political elites

Source: own illustration.

The observable implications (or predictions) of the hypotheses are the empirical consequences thereof. As Bennett and Checkel put it: ‘theories are seldom specified in such a precise ways that they offer tight predictions on the observable implications that should be evident in particular case’ (2015: 23). In this dissertation I expect to find the following observable implications of my hypothesis: economic threat in the

form of the sovereign debt crisis, the tax rebellions, an economic depression etc. as perceived by the political elites.

The observable implications should be distinguished from the evidence. An observable implication is what a chosen theory implies, in other words - it is the prediction of the theory of what we should find empirically. The observable implications are not necessarily a part of reality - they are part of a given theory, as they are their empirical consequences, implications or facts that we should find if the theory is correct. Whether we find (or 'observe') them in the gathered evidence depends on how well the theory, from which we derived the observable implications, explains our phenomenon. In specifying the kind of evidence, which the theory implies, one can proceed in two stages. First, if a theory is true (or rather: if it correctly explains chosen phenomena), then one should be able to find a number of the observable implications (for instance, an economic depression). Only afterwards one looks for the evidence of these observable implications, or predictions. Second, if the observable implication is true then I should find a number of evidence in the empirical data, which would confirm those implications (for instance documents written by the political elites in which they mention such economic depression). My chosen theory specifies the predictions as outlined in Chapter 2.4, which I should observe if it is correct. Next, I gather relevant evidence to see if it supports the observable implications of the theory, as shown in Table 1. In this dissertation, I will need to observe that the actors involved in the fiscal bargain were writing about the threat. I need to proceed inductively to some extent - based on evidence I collect, but then my hypothesis must be tested with further evidence. I tried to follow all these steps in my empirical chapters, namely Chapters 4 and 5, but also while collecting data, a topic I discuss in the next section.



### 3.3 Data collection

I collected and analyzed original evidence from primary sources in both empirical Chapters 4 and 5. In Chapter 4 devoted to the US case, I did an original work on the primary sources that were collected and published in the Kaminski, John P., Gaspare J. Saladino, Richard Leffler, Charles H. Schoenleber and Margaret A. Hogan. (eds) (1976-), *The Documentary History of the Ratification of the Constitution*. Madison, Wisconsin (abbreviated as 'DHRC'). Moreover, I used the following collection of primary sources: Syrett, H. C. (ed.) (2011), *The Papers of Alexander Hamilton*, Vol. IV-V, Charlottesville: University of Virginia Press (PAH); Abbot, W. W. (ed.) (1995), *The Papers of George Washington: Confederation, Series*, Vol. II-IV, Charlottesville: University of Virginia Press (PGWCS) and Max Farrand (ed.) (1911), *The Records of the Federal Convention of 1787*, Vol. I-IV, New Haven: Yale University Press (RFC).

In chapter 5, devoted to the EU case, I also relied on primary sources, for instance the official documents of the European Commission, or the documents, in which the EU member states provided their preferences on a number of issues regarding the future of the EU, including its fiscalization. Admittedly, these 'contributions' of the member states, as they are called, are not a perfect source, but they do have a number of advantages. First, all the members states answered the same set of questions, including the one about the prospect of fiscalization of the EU. Second, an analysis of such a official 'survey' among the governments of the member states allows for a more holistic view than other types of sources, for instance, interviews. Third, by categorizing the arguments used by the member states, in the official documents in which they stated their preferences, I can test my hypothesis, and consequently check if a threat factor played a prominent role in this debate.

The empirical Chapters 4 and 5 employ document analysis as a main method for gathering information needed to test the hypothesis outlined in Chapter 2.4. The document analysis stage starts with the collection of primary sources, mainly official documents, such as legislative texts, declarations, speeches, press releases, minutes from the ratification conventions of the US Constitution etc., but also - pamphlets, letters and newspaper articles, such as *The Federalist*. I then review and analyze this data. This part of the empirical analysis will be concluded with the examination of findings in light of formulated hypothesis.

Although some scholars argued, that 'interviewing is often necessary for establishing motivations and preferences' (Rathbun 2008: 690) I decided not to conduct interviews in order to allow for an equal treatment of my two cases. As the aim of this dissertation is to discover motivations in *both* the 18<sup>th</sup> century US and the modern EU, and as - unfortunately - I cannot interview Alexander Hamilton or the other Framers, I decided to rely on the written documents in both cases.<sup>21</sup>

In this dissertation two citation styles have been used. First, in-text parenthetical citations (author-date), the most common for political science, have been used for secondary sources. Second, citations in footnotes, most commonly found in the discipline of history, have been used for primary sources, which are less appropriate for the author-date style. The reason for such differentiation of citation styles lies in the nature of this comparative study, which has extensively used primary sources. I made an exception for *The Federalist*, which is more appropriate for the author-date style, as the essays are easily accessible and can be easily referred to in such a format. A number of each essay is always provided. This differentiation of citation styles allows the reader for an easy identification of the given source. Moreover, due to the extensive use of primary sources, the bibliography has been divided into two parts: primary and secondary sources. The narrative has been enriched by the use of the

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<sup>21</sup> I am grateful to Alexander Trechsel and Stefano Bartolini for pointing this out to me.

iconographic material - tables and figures and the original quotes within the text. The full original quotes are provided in the footnotes, which allows the reader for an easy consultation of the original text. Three empirical chapters (numbered 4, 5 and 6) conclude with a summary, which allows for the systematization of the narrative and for highlighting of the most important findings. The italics and capitals, if not stated otherwise, used in the quotations are part of the original text. I used abbreviations throughout the text, and for the sake of the flow of the narrative<sup>22</sup>, I did compromise on the consequence and as a result I did introduce the abbreviations several times, if they appeared in more than one section.

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<sup>22</sup> And in order to make it easier for the reader to follow admittedly wide range of - not always common - abbreviations (such as CSRs, MTOs, MIP etc).

# PART II EMPIRICAL ANALYSIS

## 4 Fiscalization of the US Federal Government

*Americans tend to see the Constitution and indeed the very existence of the United States of America as if it were somehow inevitable. Of course they were not. Quite the contrary, America's foundation document was in fact the product of intense negotiation, compromise and even intrigue. Indeed, the very idea of a 'United States' of America was for many revolutionary leaders - a dangerous idea.*

Sven Steinmo<sup>23</sup>

### 4.1 Introduction

The original contribution of this chapter lies in a demonstration that an endogenous threat was the main factor leading to fiscalization of the US federal government<sup>24</sup>. More specifically, it was a perception that the sovereign debt crisis constitutes such a threat, which triggered the emergence of the federal government's power to tax. I show this by analyzing primary sources from the period, as explained in Chapter 3.3.

This chapter sets out to answer the research question as outlined in Chapter 1.3 and consequently to test the hypothesis, as presented in Chapter 2.4. Namely, I analyze

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<sup>23</sup> *The Wealth of a Nation*, unpublished manuscript, 2017: 2.

<sup>24</sup> See Chapter 1.5 for the details of the original contribution to knowledge of the dissertation in general, and this chapter in particular.

the political and economic history of the period and the arguments used during the ratification of the Constitution, where the fiscalization process, as defined in Chapter 2.3 was completed - i.e. the federal government was given an independent source of revenue in the form of virtually unlimited power to tax. In order to do so, I made an extensive use of the sources from the period. I first analyzed the economic situation at the time, showing that a threat was a leading force leading to the Philadelphia Convention, where the Framers - i.e. the political elites, who gathered there, drafted the Constitution, which was later on ratified by the states. Second, I went to the sources of the period in order to collect and analyze the relevant documents (such as minutes from the ratification conventions, pamphlets, newspaper articles, speeches etc. - see Chapter 3.3 for details of data collection) in order to unravel the main arguments that were used in favor and against fiscalization, to which I will delve deeper in the second part of this chapter.

Admittedly, a boost of federal expenditures occurred during the wars, like the War of 1812 with Britain, the American Civil War or the two World Wars, as well as during the economic crises (especially during the New Deal). However, this dissertation is not concerned with the dynamics of the federal expenditures. Rather, its goal is to determine the conditions under which the federal power to tax is likely to emerge in the first place. What is important, and this is in line with Riker's theory, is not the *objective* economic or military situation, but *the perceptions* of the political elites who had the power to ratify or reject the Constitution. I argue that these perceptions centered on two interconnected themes - debt crisis which led to tax rebellions and which at some point were perceived by the political elites as an existential threat. In the following section I will demonstrate that just like in the case of the creation of the Confederation (originally called the 'Association'), when the leading motive of the participating colonies was an external military threat from Britain; in giving the power to tax to the federation the existence of an endogenous economic threat constituted such a motive.

## **4.2 How did fiscalization of the US federal government emerge?**

### ***4.2.1 Historical background***

This section provides the background to the American fiscal history of the pre-Constitution period, showing the origins of federal tax power and the consequences of the lack thereof. The period can be divided into two phases. The first, 1774-1781, concerns the First (1774) and Second (1774-1781) Continental Congress, which were attended by representatives from the North American British colonies (after 1776 – states). The Congress' main aim was to co-ordinate the actions of the colonies in their struggle against Britain. This struggle - which turned into the American Revolution - started as the result of taxes which the British imposed on the colonies without their consent, by means of the British Parliament, where the colonies were not represented. The First Congress formed the 'Continental Association' in 1774 to co-ordinate the boycott of British goods. As a result of the unresponsiveness of King George III to the colonists' petitions, Congress went on to draft the Declaration of Independence in July 1776, followed by the American Revolutionary War, which lasted until 1783, when Britain was finally defeated. Congress drafted the first US constitution, the Articles of Confederation, already in 1777, but this was not ratified until 1781. This is when the second phase of the period started, the phase which concerned the Confederation Congress of 1781-1789. Despite their different legal grounds, the Continental and Confederation Congresses had one thing in common – a lack of power to levy taxes.

The first Continental Congress gathered in September 1774. At that time it was a loose association of the representatives of the colonies, as a real government did not exist. There was no federal executive or judiciary. Congress did not have any tax powers and in financing its activities it relied on three main sources: printing money ('bills of credit'), contributions from the states, called requisitions, and borrowing (both domestic and foreign). The states were extremely reluctant to provide Congress with financial means; as a result, the main component of its revenues was 'paper money' (\$38 million out of \$68 million of the total income between 1775 and 1783) and loans of \$19 million (Dewey 1968). It is not surprising that Americans were reluctant to give the power to tax to the Congress, since they were accustomed to deal only with their respective colonial governments. However, it was given some, albeit limited, competences (the establishment of post offices, co-ordination of states' war efforts, and later the creation of a Continental Army, among others), and these activities had to be financed in some way. At this stage, the Congress could only make recommendations to the states - it did not have any power of coercion. Thus, in order to finance its expenditures, it had to ask for requisitions from the states, and the classic free rider problem emerged; consequently, the states failed to meet their obligations. For instance, between November 1777 and October 1779 Congress asked for four requisitions amounting to \$95 million, but the states provided just \$54.7 million. Moreover, from three calls between August 1780 and March 1781 amounting to \$10.6 million, the states provided just \$1.6 million. In total, before 1784, the states contributed only \$5.8 million in specie value, i.e. cash in the form of gold or silver coins, to Congress, which fell far short of the amount needed to finance its expenditures (Dewey 1968: 44-45). As Baack shows (2001: 654), before 1781, requisitions provided only four percent of Congress's revenue.

As a result, between 1775 and 1779, Congress was forced to authorize as many as forty issues of bills of credits amounting to over \$241 million (Dewey 1968: 36). Moreover, instead of rendering the Continental bills of credit, states were making

their own issues. The result was a strong depreciation in the value of the national currency. In fact, there was such a fear in Congress that the currency would not be accepted that it asked states to enact laws that would treat anybody who refused to accept Continental bills of credit as 'an enemy of his country' (Dewey 1968: 39); this time the states followed its recommendation.

At the beginning of the 1780s, there was a common understanding among the states that this system simply was not working and some proposals for establishing a national tax were put forward in Congress. In 1781, Congress recommended a 5 % duty on imports. However, this proposal required constitutional amendment and, under the Articles of Confederation, the unanimous consent of all the states was required. All but one state agreed on such a measure. The only state rejecting the measure was Rhode Island, the same state that a few years later refused to send its delegates to the Philadelphia Convention, which objected to such a duty on the grounds that the burden for commercial states from the North would be higher; that Congress could spend its revenues on any expenditure for an indefinite period of time; and that collectors would only be responsible to Congress and not to the states. In addition, proposals on a land tax, poll tax and excise tax failed in both 1781 and 1782. A proposal from 1781 that had been rejected by Rhode Island was put on the table again in 1783 as a national tariff. This time the concerns of Rhode Island were addressed - state, and not national, officers were to collect the revenues and the tariff was designed for a 25-year period in order to pay only for the national debt.

Thus, its aim was strictly limited and the revenues coming from this tariff could not be spent on anything else. It took several years for the states to deliberate this plan, but finally, in 1786, all the states but one agreed on it. This time, New York vetoed the proposal, and, as a result, the Congress was still fiscally powerless (Studenski and Krooss 2003). Congress proved unable to amend the Articles in the 'vital particular upon which all else depended - federal power of taxation', which showed its



inherent difficulty of securing unanimous agreement to any proposal (Ferguson 1961: 334, 337). This simply confirmed the perception that Henry Knox expressed a few years later, when he wrote in a letter to George Washington that 'Every State considers its representatives in Congress not so much the Legislator of the whole union, as its own immediate Agent or Ambassador' (Maier 2010: 14).

#### ***4.2.2 The argument – fiscalization as a result of a threat***

The sovereign debt crisis that emerged in the mid-1780s had its roots in the long and expensive Revolutionary War. As Congress did not have any tax power, and as the borrowing (on the credit of the states) and the policy of monetary financing the expenditures of government had reached its limit (inflation was so enormous that the term 'not worth a Continental' was coined, which referred to the national currency), the fiscal burden of financing the war efforts fell on the states. In a majority of these, at least two-thirds of tax revenues were devoted to the payment of war bonds. In order to pay off these debts, between 1781 and 1790 states imposed heavy taxes that 'averaged three or four times those of the colonial era' (Holton 2005: 445). One historian estimated the increase of the average per capita tax burden to be even sevenfold (Brown 1993: 33-34). What is more, during this fiscal crisis, unlike in the EU, there was not yet a monetary union, and so states were free to use monetary means to finance their needs. Moreover, this monetary financing only accelerated fiscal stress on the citizens - depreciation of the paper currency was so serious that Benjamin Franklin said it acted 'among the inhabitants of the States...as a gradual tax upon them' (McCusker and Menard 1991: 373). Yet despite these monetary tools, the states still had to use unpopular taxes to pay off the debts (Sylla 2006: 73-95).

I argue that the sovereign debt crisis of the states in the mid-1780s triggered the chain of events, which paradoxically led to the fiscal bargain and the emergence of the federal power to tax. The federal budget based on contributions created a system in which states had to tax heavily in order to pay off the debt in 1780s. These taxes and the general perception of injustice led to popular unrests, such as the one led by Daniel Shays<sup>25</sup>, a revolutionary veteran who rebelled against the tax policy of the government of Massachusetts in 1786/1787. This kind of rebellion was seen as an existential threat for the young republic and ‘had convinced many Americans that constitutional reform was imperative’ (Klarman 2016: 72). The perception of such threat helped the Federalists (or the Nationalists, as they were sometimes called) to convince the political elites from almost all the states that the federal power to tax was inevitable for the peaceful existence of the Union. Indeed, as one historian observes: ‘Shays's Rebellion was consciously exploited by leading Nationalists in search of a common danger to unite the country’ (Ferguson 1961: 249).

There are also alternative explanations on why the federal government was given the power to tax and they usually evolve around Federalists’ desire to restore public credit. True, if the only purpose of the elites was to avoid tax revolts, then the easiest way would be default, since the high taxes were imposed to redeem public debt.<sup>26</sup> But this option was ruled out. There is no agreement in the literature, however, why Federalists decided to restore public credit: for their personal gains (Beard 1913, Holton 2005), to kick-start the economy (Sylla 2011) or to strengthen the defence capacity of the new government (Edling 2003). Whatever the reasons behind the restoration of public credit, the fact remains that it would be very difficult to achieve without fiscalization. In turn, the tax revolts created conditions under which the states were willing to agree on such fiscalization.

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<sup>25</sup> For the history of this rebellion see Richards (2002).

<sup>26</sup> I am grateful to Max Edling for this suggestion.

In the majority of the states, people who were often Revolutionary War veterans were now turning their arms against state governments because of the heavy tax burdens (Brown 1993: 32-138; Perkins 1994: 137-196). Ferguson demonstrates how widespread both the actual unrest and the fear thereof (that is to say, the perception of a threat) were: 'Madison saw Shaysism emerging in Virginia. (...) Mobs besieged the legislature of New Hampshire and stopped courts in eastern Connecticut; an 'insurrection' was put down in Vermont. Trouble was expected in New York, where the militia was readied to intercept refugees from Massachusetts' (Ferguson 1961: 249-250). There was a risk that such tax revolts, like Shays's Rebellion, would spill over to the other states and would put the very existence of the union in jeopardy. Hamilton was convinced that the cause of this social unrest laid in the onerous tax burden of the state legislature - he wrote that 'the insurrection was in a great degree offspring of this [tax] pressure' (Chernow 2004: 225). In order to prevent such social unrest from happening again, action had to be taken with regard to its cause - by relieving the heavy state tax burden. Paradoxically, this relief was done by granting the federal government the power to tax, which then helped to lighten the burden of states' taxation. This paradox was possible for several reasons.

First, it was expected that a tariff will be the main federal tax, and it was in the interest of majority of the states that this tax on imported goods will be taken by federal government, because only few coastal states with ports could impose, and benefit from, a state tariff. As citizens of non-coastal states were also consuming imported goods, they were effectively paying taxes of coastal states (which were included in the price of those goods). Importantly, the coastal states, like New York, that had the most to lose from the introduction of the federal tariff and the abandonment of state tariffs, also had the most to gain from the provision of a 'common defence' for which revenues from federal tariff would be spent, as they were most

exposed to a danger of foreign invasion. Therefore, the agreement of the coastal states was achieved by connecting tariff and military expenses.

Second, it was expected that the federal government will be able to collect more revenues from the tariffs, than states were able to do separately, because the tax competition will disappear, and one tax rate throughout the country will be established. Indeed, as Table 2 shows, when the federal government took over the power to levy tariff (custom duties), the total revenue increased by six hundred percent within a decade.

Third, this revenue was expected to pay for national debt and in so doing to free the states from this burden. It was important, because funds borrowed by the Congress (domestic bonds, debt certificates, and foreign loans) amounted to 32 mln pounds sterling, and were much larger than those borrowed by the states - their indebtedness equalled 23 mln pounds sterling.<sup>27</sup>

Fourth, states were no longer obliged to collect money for the federal government, neither for the current federal expenditures, nor for the 'common defence', the most expensive spending item of a government that time. Finally, the anticipated federal tax, the tariff, was an indirect tax and was thus paid only by 'monied' men who could afford imported goods and for that reason was not expected to cause social unrest. Therefore, for those five reasons, such a paradox was possible - in order to tax less, the states had to give a power to tax to the Union. As a result, transfer of fiscal power resolved the issue of high taxation, a source for internal threat undermining a new Union.

The states had different levels of debt, which reflected both their level of involvement in the war and the amount they managed to pay off after the war. Certainly, these differences played an important role in the states' reaction to Hamilton's debt

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<sup>27</sup> In total borrowed funds covered 33% of the total cost of war, while fiat (paper) currency - 67% (28% in Congressional monies, and 39% in States' monies), Perkins 1994: 103, table 5.4.

assumption plan, proposed once the Constitution was ratified and the federal government could use its fiscal capacity (Steinbach 2015: 1114).

**Table 2. Customs receipts in four major ports**

State	1785-1788	1792-1795
New York	\$ 603,000	\$ 4,653,000
Philadelphia	622,000	4,299,000
Baltimore	346,000	1,829,000
Charleston	404,000	1,064,000
Total	\$1,975,000	\$11,845,000

Source: Edling and Kaplanoff 2004: 739.

However, what is crucial to my argument is not so much the level of debt of the individual states *per se*, which was much higher compared to the debt from the previous conflict - the Seven Years' War, 1756-1763 - as 'the net financial burden (...) was up to ten times greater per capita' (Perkins 1994:137), but the level of direct taxation. In this regard, almost all the states imposed significantly higher level of direct taxation, which in the 1780s on average provided two-thirds of states' tax income, but were diminished by at least 75 percent in the majority of the states (and three states abandoned it completely) just few years after the Constitution was ratified,

and '(b)y the early 1790s, after a decade of heavy and unpopular taxation, state taxes had returned to the low level of the colonial period' (Edling and Kaplanoff 2004: 723, 734).<sup>28</sup> It was fiscalization of the federal government that allowed for such a tax relief.

The social unrest, especially Shays's Rebellion, was perceived by the American elites as a threat, including the most important figure, the 'Father of the Nation' George Washington: if such a rebellion could take place in New England, it could easily happen in Virginia, where plantation owners controlled the state governments and small farmers had little say in politics. John Jay was not the only one who was reporting to Washington that the situation in the summer of 1786 was so serious that it may lead to some revolution of extraordinary consequences for the young republic: 'Our affairs seem to lead to some crisis - some Revolution - something I cannot foresee, or conjecture'.<sup>29</sup> As a prominent historian of that period points out about the US in 1788/1787: 'The situation amounted to a crisis of unprecedented importance of the young republic. For those caught up in that frame of mind, the entire future of the United States was at stake' (Maier 2010: 17). Admittedly, the economic threat was not isolated and as it triggered social unrest, one could argue that it developed into a more general, internal threat, which was best exemplified when the debtors took up the arms and were fighting against the fiscal measures, which were being imposed on them by the state governments. Nevertheless, it was the economic threat, which triggered a chain of events leading to fiscalization of the federal government.

Washington was one of those 'caught up' in the conviction that this crisis was a threat to the future of the US and only a more energetic federal government (and the power to tax was one of the most important authorities proposed for this new

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<sup>28</sup> '[It] is known that the State taxes have generally been very inconsiderable' as Secretary of the Treasury Oliver Wolcott declared in 1796 (citation from Edling 2014: 52).

<sup>29</sup> 'To George Washington from John Jay, 27 June 1786', PGWCS IV: 130-132.

government) could provide a permanent solution. As he wrote to Henry Knox, a man who was reporting to him about the ‘Lamentable’ developing of the ‘Insurgents of Massachusetts’ in December 1786:

If the powers are inadequate amend or alter them, but do not let us sink into the lowest state of humiliation & contempt, & become a byword in all the earth—I think with you that the Spring will unfold important & distressing Scenes, unless much wisdom & good management is displayed in the interim.<sup>30</sup>

He also feared that Britain would take advantage of ‘disorders’ which have arisen in these states: ‘That G.B. [Britain] will be an unconcerned spectator of the present insurrections (if they continue) is not to be expected.’ Moreover, he wrote that ‘(t)here are combustibles in every State, which a spark may set fire to’ and in Virginia, the most populous and affluent state, an American equivalent of Germany in the EU, ‘disposition to support, and give energy to the foederal system is discovered’ and so ‘it seems very desirous of a General Convention to revise and amend the federal Constitution’.<sup>31</sup> I argue that it was the tax-motivated political turmoil that convinced the elites in 1787 to ‘revise’ the Constitution - the Articles of Confederation, so soon - only six years after it was ratified. Indeed, we have a lot of evidence to suggest that Washington decided to attend the federal convention in Philadelphia after learning about Shays’s Rebellion from Knox’s letters.<sup>32</sup> It was, in fact, Washington’s presence that was crucial to the success of the convention in drafting the Constitution that was later ratified by the states (he had been elected to the role of president of the convention). And within the Constitution, the principal transformation was the federal power to tax, as Hamilton reminded his fellow New Yorkers

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<sup>30</sup> ‘From George Washington to Henry Knox, 26 December 1786’, PGWCS IV: 481–484.

<sup>31</sup> ‘From George Washington to Henry Knox, 26 December 1786’, PGWCS IV: 481–484.

<sup>32</sup> See Maier (2010: 11-26), where she provides excellent analysis of the letters Washington was receiving about the popular unrest from John Jay, James Madison and Henry Knox, among others, which confirmed his fears that the Union is on a brink of collapse.

during the battle for ratification: 'I have applied these observations thus particularly to the power of taxation, (...) because it is the most important of the authorities proposed to be conferred upon the Union' (*Federalist* 33, PAH IV: 466).

The key to my argument, and it is in line with Riker's theory, as outlined in Chapter 2.2 and consequently - my hypothesis (Chapter 2.4), is not so much the 'objective' economic or military situation of the period, but the perceptions of the key actors, i.e. the Framers of the Constitution - the delegates in the Constitutional Convention. I argue that these perceptions in 1786/1787 centered on a sovereign debt crisis followed by heavy state taxes that led to popular unrest, which was perceived as an internal threat. This threat undermined the status quo and triggered the emergence of the federal power to tax. Hamilton was not the only person to warn against the dangers of the tax rebellions - he was afraid that the social unrest, like the rebellion of debtor farmers in Massachusetts - the 'tempestuous situation' as he called it, would lead to 'tyranny' or 'despotism' in the state, and that these 'convulsions' might spill over to other states (*Federalist* 21, PAH IV: 397-398). The fact that '(...) the situation in Massachusetts was an extreme case of a widespread problem' shows that those fears were justified (Maier 2010: 15).

By linking the debt and power to tax, I have shown the mechanism of the emergence of the federal power to tax: 'As the states laid hands on the public debt they undermined the basis for a constitutional enlargement of federal powers' as a leading historian observes about the situation in the mid-1780s (Ferguson 1961: 221). However, the way in which the states decided to pay off this debt - through onerous direct taxation - changed the political dynamics and paved the way for the enlargement of the federal powers. As a consequence, it can be said that the process of fiscalization of the central government had begun. Importantly, fiscal policies of states' governments fueled the feeling of injustice and consequently had caused widespread social unrest, whereby the cause of such a feeling of injustice lay in 'state legislatures, many of which imposed disastrous austerity policies simply to



pay wealthy bondholders' (Mihm 2012: 342). I claim that in this way states helped to spark the process of fiscalization of central government. As Brown (1993: 234) observes: 'state taxation holds the key to the Framers' decision to reconstitute the Republic rather than amend the Articles of Confederation, when amendment would have been the simpler solution'.

Such a 'reconstituted' union would have a more 'energetic' federal government, which could levy taxes (and pay for 'common defence' and other duties that states had had to pay for until now) that were not such a burden for the average citizen. Simplifying greatly, there were two types of taxes: direct and indirect. People were usually much more concerned with the former type, because its payment is in cash. Indeed, heavy direct taxes had been the main cause of Shays's Rebellion. Indirect taxes, on the other hand, were usually feared less, as they were included in the price of goods, and, in general, they could be avoided by not purchasing those goods. The first clause of Section 8 of Article I of the Constitution gave the federal government virtually unlimited power to tax: 'The Congress shall have Power To lay and collect Taxes, Duties, Imposts and Excises, to pay the Debts and provide for the common Defence (...)'. However, during the Ratification it was widely assumed that the tariff would normally be sufficient to cover federal expenditures. And so it was - until the Civil War tariff provided over 90 % of the federal revenues (Woźniakowski and Steinmo 2018); between 1801-1812 and after 1817 it was the only federal tax (Einhorn 2006: 111). This tax had the advantage of being an indirect tax; it was collected at the ports from merchants, who then included it in the prices of the goods they imported.

The internal crisis led the Framers to the conviction<sup>33</sup> that giving the power to tax to the new federal government is absolutely essential. As Klarman (2016: 145) puts it:

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<sup>33</sup> For instance, when Edmund Randolph presented the Virginia Plan, which opened up the Convention, he started with the analysis of the situation of the Union. Four out of six problems he iden-

‘The consensus among delegates for empowering Congress to levy taxes (...) was so strong that little discussion was devoted to the subject.’ Although the delegates did not waste their time deliberating on a principle on which nearly all of them agreed, they did discuss the details of this principle. Two proposals proved to be especially controversial: a ban on taxing the slave trade and direct taxation. The precise nature of the fiscal bargain was a result of the negotiations regarding those two issues, and the sectional interests of the Southern and Northern states had to be compromised for the sake of the Union.

The ban on taxing or regulating the slave trade was proposed on August 6, 1787 by the Committee of Detail, under the influence of the Southern states, which feared that such a tax would mainly affect their export-driven slave economies. This proposal met with the resistance of the other states. To resolve the issue Gouverneur Morris proposed to merge it with the two other contested proposals presented by the Committee’s draft constitution: on a requirement of two-thirds majority for the commercial regulation in both houses and the ban on taxing exports, to be sent back to the Committee and be negotiated as a package. As Morris envisioned: ‘these things may form a bargain among the Northern & Southern States’ (citation from Edling 2014: 39-40)<sup>34</sup>. Indeed, it only took two days for the Committee members to struck a bargain: the ban on taxing exports prevailed, but the requirement of a two-thirds for commercial regulation was struck out (a concession for the North), and the Congress was allowed to legislate on the slave trade, including taxes on imported slaves, after 1800, which was later changed for 1808, and a limit of ten dollars per slave was introduced for import duties (Jillson 2002: 146).

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tified concerned revenue: ‘inefficiency of requisitions’; ‘rebellion (...) as in Masss.’ led by Daniel Shays; urgency of foreign debt; and ‘the havoc of paper money’ (RFC, I: 18-19).

<sup>34</sup> Edling refers to him simply as Morris, but the index of his book indicates that it was Robert Morris, while in fact it was Gouverneur Morris, who proposed this bargain (see the original source: RFC II: 374).

Another example on how this fiscal bargain came about was the direct tax clause. Here, it was connected with representation - any direct taxes would have to be appropriated among the states based on their population, where slaves would be counted as three-fifths of a person. The same principle would be applied in counting the number of representatives from each state in the House of Representatives. As a result, the compromise between the two distinct groups of states was found and a fiscal bargain was struck (Edling 2014: 38-41).

A detailed analysis of the arguments surrounding perhaps the most controversial clause of the Constitution - the federal power to tax – and which were used during the ratification process is a topic of the following Chapter 4.3. It is, nevertheless, worth noticing that there was an agreement among the elites of the US about the need for a federal power to tax, that even the Anti-Federalists, who were opposed to the new Constitution, supported it. For instance, Brutus, one of the main Anti-Federalists, argued the following:

*first includes impost duties on all imported goods; this species of taxes it is proper should be laid by the general government; many reasons might be urged to shew that no danger is to be apprehended from their exercise of it. They may be collected in few places, and from few hands with certainty and expedition. But few officers are necessary to be employed in collecting them, and there is no danger of oppression in laying them, because, if they are laid higher than trade will bear, the merchants will cease importing, or smuggle their goods. We have therefore sufficient security, arising from the*

*nature of the thing, against burdensome, and intolerable impositions from this kind of tax.*<sup>35</sup>

He, therefore, believed that this mode of taxation would be safe because by its nature it placed a limit on the degree of burden that could be imposed (otherwise, smuggling or a decline in tax revenues would ensue). Einhorn (2006: 149) has indeed shown that the tariff was widely seen as an appropriate tax for federal government.

To sum up, the sovereign debt crisis<sup>36</sup> during the post-war economic recession in the mid-1780s was one of the main reasons behind the drafting of the Constitution and it was the single-most important cause of the federal power to tax clause. The social unrest in the form of the tax protests of 1786-1787 constituted an internal threat for the new union. As Maier points out, '(p)opular unrest in the fall and winter of 1786-1787 brought those fears [of a dissolution of the democratic union] to a peak' (2010: 15). Indeed, the elites, including George Washington and Alexander Hamilton, feared that people would turn away from such a union if it only seemed to bring them economic hardship. This fear over protests united the elites who formed a coalition in favor of a strong federal government: 'the movement for constitutional revision derived much of its impetus from conservative fear of social radicalism' (Ferguson 1961: 337). The federal tax power was viewed as the most important mean of preventing such crises from threatening the existence of the union in the future (also a very near future, as it was far from certain that rebellions similar to the one led by Shays would not outbreak again if the present financial arrangement will continue to exist), because of a less intrusive nature of a federal tariff, as opposed to the direct taxation used by the states.

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<sup>35</sup> Brutus V, New York Journal, 13 December 1787, DHRC XIX (1): 415.

<sup>36</sup> I call the debt crisis and the social unrest which followed, a sovereign debt crisis, because the states which issued excessive debt in fiscal matters were the sovereigns of the US Confederation.

While extremely important, this was just one of many arguments that were put forward during a great debate on the ratification of the US Constitution, both in favor and against the idea of fiscalization of the federal government, a topic I delve deeper in the following section.

## 4.3 The debate on the US Constitution: the main arguments in favor of and against fiscalization of the federal government

The aim of this section is to demonstrate the main arguments regarding the federal power to tax used by both Federalists and Anti-Federalists in the state of New York during the ratification process in 1787-1788. I will do so to test my hypothesis - I expect to find references to the economic threat in the arguments calling for fiscalization. New York was a key and representative state for several reasons, as explained in Chapter 3.1. One of the main reasons is the fact that the arguments provided in New York State are likely to represent the whole spectrum of arguments used elsewhere.

A detailed analysis of the arguments in favor and against fiscalization of the US federal government, which were used during the ratification process is the scope of this section. In New York State, as well as in the US in general, the most important piece of writing concerning taxation was *The Federalist*. Alexander Hamilton who published these essays together with James Madison and John Jay under the pseudonym *Publius*, devoted seven essays (out of 85), numbered 30 to 36, exclusively to the federal power to tax, in addition to other essays in which this clause is also discussed. Overall, approximately one in eight essays of *The Federalist* deals, more or less extensively, with one sentence of section 8, art. 1 of the Constitution: 'The Congress shall have Power To lay and collect Taxes, Duties, Imposts and Excises, to pay

the Debts and provide for the common Defence and general Welfare of the United States; but all Duties, Imposts and Excises shall be uniform throughout the United States’.

Clearly, it shows the importance of this clause. Essays 30-36 were written in January 1788, three months after the Constitution was submitted to the states for ratification and half a year before the New York ratifying convention convened. Hamilton tried to be comprehensive and to address all the major criticisms of the federal power to tax. The debate was fierce and many arguments were not new; some of them were used against proposals for federal power over impost already in 1781 and 1783. Hamilton succeeded in capturing the main arguments of his opponents and he consequently laid down powerful arguments in favor of fiscalization<sup>37</sup>, and how it would benefit the people, the states and the union as a whole.

This analysis is complemented by other sources from the period – newspaper articles and the pamphlets of Anti-Federalists, mainly Brutus and Federal Farmer, who were the major figures opposing the Constitution, as well as discussions during New York ratifying convention.<sup>38</sup> I divided the arguments into three main categories: the negative consequences of the requisition system, i.e. the current system at the time, based on states’ contributions and the positive, as well as the negative consequences of such a power. Tellingly, there is no such category as ‘the positive consequences of the requisition system’, as opponents of such a power did not advance any explicit advantages of this framework of financing the Union.

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<sup>37</sup> Following the nomenclature from the period and for the sake of simplicity in this chapter I treat the concepts of ‘fiscalization’ and ‘the power to tax’ simultaneously.

<sup>38</sup> For the discussion on why taxation was the most important issue in New York State, debated for five days during the convention, along the issue of representation, and why federal taxation was most comprehensively discussed in New York, see Chapter 3.1, as well as Maier 2010, 320-400, especially 362-369.

### ***4.3.1 The negative consequences of the requisition system***

#### ***4.3.1.1 Plunder of the people and ‘atrophy’ of the union, followed by its dissolution***

Alexander Hamilton argued that money is essential for the execution of the function of every government, and this can be easily found in a constitution of any nation. Government must have ‘a complete power’ over money, which would guarantee ‘regular and adequate’ revenues. Only the power to tax, which guarantees financial autonomy from the states, can ensure that the stream of money will come on regular basis and in the amount which central government finds necessary.

*Money is, with propriety, considered as the vital principle of the body politic; as that which sustains its life and motion, and enables it to perform its most essential functions. A complete power, therefore, to procure a regular and adequate supply of it, as far as the resources of the community will permit, may be regarded as an indispensable ingredient in every constitution. From a deficiency in this particular, one of two evils must ensue; either the people must be subjected to continual plunder, as a substitute for a more eligible mode of supplying the public wants, or the government must sink into a fatal atrophy, and, in a short course of time, perish.<sup>39</sup>*

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<sup>39</sup> *Federalist* 30, PAH IV: 450.



If the Constitution fails to ensure that this kind of fiscal autonomy is given to the federal government, Hamilton continued, then two ‘evils’ will develop. Faced with the lack of money, the federal governments will turn into a ‘continual plunder’, will take the property of the people to finance its own needs to ‘substitute for a more eligible mode of supplying the public wants’. The second danger of this ‘deficiency’ is the ‘atrophy’ of the government, which eventually will completely disappear. Ultimately, either there is a ‘vibrant general government’ with a power to tax, or there is no union at all, Hamilton asserted.

#### *4.3.1.2 States constantly negotiate the level of their contributions*

The reasons that the delegates of the ratification convention gave to justify the federal power to tax was a failure of the previous system of financing the federal government. Hamilton maintained that states never took into consideration the interest of the union as a whole when considering compliance with the federal requests for requisitions, but only their own needs,<sup>40</sup> and consequently would comply only if it was in their interests; for instance, when war was fought on their territory and they needed a federal army.<sup>41</sup>

No wonder, he seemed to think, that states that were not facing any threat of invasion did not comply with the requisitions’ calls; it is human nature to look at self-interest and the same principle applies to the states. If one gives states a choice and the right to refuse adoption of the federal measure, a state would comply only if it

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<sup>40</sup> ‘the States have almost uniformly weighed the requisitions by their own local interests; and have only executed them so far as answered their particular conveniency or advantage’, *New York Ratifying Convention. Remarks* (FRANCIS CHILDS’S VERSION, [20 June 1788]’, PAH V: 18.

<sup>41</sup> ‘While danger is distant, its impression is weak, and while it affects only our neighbours we have few motives to provide against it’, *New York Ratifying Convention. Remarks* (FRANCIS CHILDS’S VERSION, [20 June 1788]’, PAH V: 18.

would be in its interest. Consequently, one may only expect compliance when a threat is present, be it an invasion of a foreign power or an economic collapse. As Hamilton noted: ‘the States have almost uniformly weighed the requisitions by their own local interests’.<sup>42</sup>

The future first Secretary of the Treasury described the legal system of public finances under the Articles of Confederation, which, at least on paper, gave Congress very strong power: it could demand from the states any sums it found necessary for the exercise of its functions, and states did not have the right to ‘question the propriety of the demand’, and they could only devise the mode, ‘the ways and means’, of how they would raise such a revenue for Congress. Hence, on paper, the fiscal power of Congress was robust. However, in practice ‘it [delay and neglect to comply with requisitions] had been constantly exercised, and would continue to be so, as long as the revenues of the Confederacy should remain dependent on the intermediate agency of its members’ (*Federalist* 30, PAH IV: 451).

#### *4.3.1.3 The coercion of states to comply with federal fiscal directives (which is madness and leads to civil war)*

The following argument, which was used by Hamilton, supports my hypothesis that fiscalization comes about as the result of a threat - for instance the threat of a civil war. Significantly, he used exactly this argument when he talked about the proposal to stay within the current requisitions system and then to give the federal government coercive powers over the ‘delinquent states’. He envisioned the danger of a civil war between such a state (and its allies which would be in a similar position) and the federal government. In his opinion, such a system is a recipe for a dis-

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<sup>42</sup> *New York Ratifying Convention. Remarks* (FRANCIS CHILDS’S VERSION, [20 June 1788]’, PAH V: 18.

aster. Hamilton seemed to understand human nature, and he frequently referred to the character of men and the need for the lawmakers to take it into account. Consequently, he called for the creation of a system of law, which would give proper incentives to people and encourage the compliance with the desired outcomes.

Paradoxically, Hamilton, the strongest Federalist of the era, who seemed to always be in favor of a strong federal government, dismissed the idea of giving the federal government a coercive power to push the states to pay. This important idea deserves a lengthy citation, because it provides a link between fiscalization and an internal threat resulting from rebellions and a civil war:

*Sir, if we have national objects to pursue, we must have national revenues. If you make requisitions and they are not complied with, what is to be done? It has been well observed that to coerce the States is one of the maddest projects that was ever devised. A failure of compliance will never be confined to a single State: This being the case, can we suppose it wise to hazard a civil war? Suppose Massachusetts or any large State should refuse; and Congress should attempt to compel them; would they not have influence to procure assistance, especially from those states who are in the same situation as themselves? What picture does this idea present to our view? A complying state at war with a non-complying state: Congress marching the troops of one state into the bosom of another: This state collecting auxiliaries and forming perhaps a majority against its Federal head. Here is a nation at war with itself. Can any reasonable man be well disposed towards a government which makes war and carnage the only means of supporting itself? A government that can exist only by the sword? Every such war must involve the innocent with the guilty. This single consideration should be sufficient to dispose every peaceable citizen against such a gov-*

ernment.<sup>43</sup>

In his view, if the federal government was to coerce the states to pay, it would lead to opposition against federation and, consequently, to a civil war, since the states in a similar fiscal situation would be likely to form a coalition against the federal government. Hamilton demonstrated how ancient leagues operated under the same fiscal principle as the US Confederation and how this led to their ruin, in the form of a civil war or the intervention of a foreign power. Such an external force would use the conflicts within the union, which are likely to be present in such a defected fiscal system. A foreign power would intervene under the pretext of helping one state and as a result it would dominate the entire union.<sup>44</sup>

To sum up, in this section I analyzed a group of arguments regarding the negative consequences of the system of financing the central government, which is based on contributions from the states - the requisition system. These arguments are the following:

1. The plunder of the people and the 'atrophy' of the Union, followed by its dissolution;
2. States constantly negotiate the level of their contributions;
3. The coercion of the states to comply with federal fiscal directives (which is madness and leads to a civil war).

The arguments were used in order to show that if the current system will continue to operate, it would lead to the 'atrophy' and the dissolution of the Union caused by the constant negotiations of the level of states' contributions. As a result, the 'plun-

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<sup>43</sup> *New York Ratifying Convention. Remarks* (FRANCIS CHILDS'S VERSION, [20 June 1788]', PAH V: 19.

<sup>44</sup> 'When a requisition was made, it rarely met a compliance; and a civil war was the consequence. Those which were attacked called in foreign aid to protect them; and the ambitious Philip under the mask of an ally to one, invaded the liberties of each, and finally subverted the whole.', *New York Ratifying Convention. Remarks* (FRANCIS CHILDS'S VERSION, [20 June 1788]', PAH V: 21.

der of the people' will ensue. Such dissolution is likely to be violent, as the coercion of the states would lead to constant disputes and finally - a civil war. As the evidence shows, a threat was a very strong component of those who argued in favor of entirely new system of federal public finances.

### ***4.3.2 The positive consequences of fiscalization of the federal government***

#### ***4.3.2.1 Federal credit and ability to borrow at low rates***

A failure to meet federal obligations that occur during a serious threat, for instance a war, when the federation would have to finance the war effort and, in the absence of tax power, would be forced to stop paying interest on its debts, would result in the termination of the ability to borrow from the markets. '(N)ations the most wealthy are obliged to have recourse to large loans', Hamilton emphasized, and the US which are not as affluent, 'must feel this necessity in a much stronger degree' (*Federalist* 30, PAH IV: 454). When creditors will notice that lending to such a government carries a significant risk because 'no reliance could be placed on the steadiness of its measures for paying', they would be reluctant to lend even small loans. And even if they would do so, the loans would come with a high interest rate ('enormous premiums'), and would be 'as limited in their extent as burdensome in their conditions' (*Federalist* 30, PAH IV: 454). The unlimited federal power to tax, even if not exercised, would send a signal to the creditors that federal government can credibly commit to service its debt, and therefore the money can be lent in large amounts with low interest rates.

One may wonder why Hamilton put so much stress on the ability to borrow? It was because such ability is practically the only way the national government can access

large amount of money on a short notice. This could only be achieved if the government had a collateral in the form of certain future revenues, which a power to tax could provide.

*Foreigners, as well as the citizens of America, could then reasonably repose confidence in its engagements; but to depend upon a government that must itself depend upon thirteen other governments for the means of fulfilling its contracts, when once its situation is clearly understood, would require a degree of credulity not often to be met with in the pecuniary transactions of mankind, and little reconcilable with the usual sharp-sightedness of avarice.*<sup>45</sup>

In the case of the outbreak of war, or any other crisis or ‘exigency’, like the economic crisis, the federal government will be put in a situation in which it will need to have a quick access to large sums of money. Even with the unlimited power of taxation, it would be hard to extract from the population enough revenue in a short period of time.<sup>46</sup> The ability to borrow also enables the government to multiply its revenue capacity. For instance, with an interest rate of 5 percent, every \$1 million raised from taxation could be turned into a \$20 million loan. The government would use its tax money to pay only for the interest of such a loan, 1 million annually, and could postpone the payment of such loan into the future tax revenues. For this reason, a credit history of the government, just like a credit history of individuals, is important. Following the previous example, it enables to raise money, for instance, twenty-fold on the financial markets (for example, if an individual has net annual income of \$30,000, one could take a mortgage worth \$600,000, which is twenty-fold as much as the annual income to leverage an asset).

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<sup>45</sup> *Federalist* 30, PAH IV: 454-455.

<sup>46</sup> ‘The power of creating new funds upon new objects of taxation, by its own authority, would enable the national government to borrow as far as its necessities might require’, *Federalist* 30, PAH IV: 454.

Cincinnatus, one of the leading Anti-Federalists, agreed that the ability of federal government to tax people directly and collect money in specie (i.e. gold or silver coins), ‘will certainly support public credit.’ However, this will be done on the expense of the people, he claimed, who will be overwhelmed and ‘it will grind the poor to dust’ while providing ‘immense fortunes to the speculators.’ He also noticed that the current government started to pay off the principal of the debt by selling western lands, and that paper money, as ‘evil’ as it is, ‘in this instance attended with the great benefit of enabling the public to cancel a debt upon easy terms’.<sup>47</sup>

#### **4.3.2.2 *A possibility to tackle future unpredictable exigencies: A Constitution written for centuries, not decades***

The arguments outlined in this section clearly support my main claim that federal power to tax emerges as a result of a threat, because such power to tax would be used in order to tackle both present and future threats, or ‘exigencies’, as Hamilton called them. Importantly, it is an argument, which was the most extensively used and it is reflected in the length I devoted for its analysis.

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<sup>47</sup> Cincinnatus VI: To James Wilson, *Esquire New York Journal*, 6 December 1787, DHRC XIX (1): 369. See also: ‘It may be said, that let the government be what it may, the sums I have stated must be raised, and the same difficulties exist. This is not altogether true. For first, we are now in the way of paying the interest of the domestic debt, with paper, which under the new system is utterly reprobated. This makes a difference between the specie to be raised of 1,800,000 dollars per annum. If the new government raises this sum in specie on the people, it will certainly support public credit, but it will overwhelm the people. It will give immense fortunes to the speculators; but it will grind the poor to dust. Besides the present government is now redeeming the principal of the domestic debt by the sale of western lands. But let the full interest be paid in specie, and who will part with the principal for those lands. A principal, which having been generally purchased for two shillings and six pence on the pound, will yield to the holders two hundred and forty per cent. This paper system therefore, though in general an evil, is in this instance attended with the great benefit of enabling the public to cancel a debt upon easy terms, which has been swelled to its enormous size, by as enormous impositions. And the new government, by promising too much, will involve itself in a disreputable breach of faith, or in a difficulty of complying with it, insuperable.’, Cincinnatus VI: To James Wilson, *Esquire New York Journal*, 6 December 1787, DHRC XIX (1): 369.



Opponents of the unlimited power of taxation claimed that the federal government does not need such a broad power and that a smaller range of power to tax would be sufficient to conduct its operations. In responding to this, Hamilton (and others), maintained that the Constitution was written to last for a long time and no reasonable man is able to predict how much money the federal government would need in the future. Especially in times of crisis, such as a war or an economic depression, the federal government has to have a power to raise sufficient amount of revenues, without asking states every time.

The key argument for the 'acceptance of the taxes' is their 'invisibility', which excludes direct taxes that citizens would have to pay in cash. Moreover, the assessment of the wealth of citizens can be difficult, as Hamilton argued, when he asserted that direct taxes will be used only in emergency case, but a source of revenues should be invisible, so the taxpayer would barely notice that she is paying tax. Two kinds of taxes fulfill this criterion. First, it is an excise tax, i.e. a tax on consumed goods, which is added to the price of such a good. It was argued that luxurious goods are the most suitable for this kind of tax, as they are not essential for living, so people have a choice whether to purchase them or not. The second tax which fulfills the criterion of 'invisibility' is a tax on imported goods, which is paid by merchants at the port of entry to the US. Similarly to the excise, this tax is included in the price of products.

The direct taxes are very different and should be avoided, because they are obligatory and thus citizens do not have a choice, like with the indirect taxes. However, as Epstein (1984: 47) showed, the future first Secretary of the Treasury dismissed critics who advocated for the complete abolishment of the direct taxation in the Constitution. He also did not think that it would be necessary to use direct taxation in normal times. However, in times of 'exigency' the use of direct taxation could be necessary.

Consequently, Hamilton argued for the necessity of giving Congress not only the power over the impost, but also the power over other resources. He understood that the Constitution was not meant to serve just for the next decade or two. It was intended to serve the nation for centuries, and therefore one cannot include provisions, which could be outdated once the demographical or economic situation of the nation changes. This seems to be the first premise from which the Founding Fathers derived their principles upon which they drafted the Constitution.

Hamilton dismissed the idea of the Anti-Federalists, who made a distinction between 'internal' and 'external' taxation, with the former being assigned to the states, and the latter to the federation. In his view, such a division would go against the principle that:

*every POWER ought to be proportionate to its OBJECT<sup>48</sup>*

Such a division would give the federation only the power over 'commercial imposts, or rather duties on imported articles, they [opponents of the constitution] declare themselves willing to concede to the federal head.' Such a consensus over impost was an achievement for him because even during the Revolutionary War attempts to introduce the impost failed. Hamilton was not, however, satisfied with such an achievement. Giving just the impost to the federation is not enough, Hamilton explained, because '[i]ts future necessities admit not of calculation or limitation'.

Therefore, no one is able to foresee the needs of the government in the future, and, therefore, its ability to raise revenue cannot be confined to the present situation, in which the nation enjoys peace, where the federal government has to have enough money just for the 'provision for the public debt and of a peace establishment for the Union.' Even if import duties would be sufficient in peacetime, then in the case of war (which would outbreak sooner or later, he stressed, and those who 'believe

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<sup>48</sup> *Federalist* 30, PAH IV: 452

we are likely to experience a common portion of the vicissitudes and calamities which have fallen to the lot of other nations' would agree), the federal government, 'unable by its own authority to lay hold of fresh resources' will be undoubtedly 'diverting the funds already appropriated from their proper objects to the defense of the State' (*Federalist* 30, PAH IV: 454). Such 'proper objects' of the federal expenditures include paying off its debts. Therefore, in the case of war, federal government would be pushed to finance the war and not to pay interest of the debt, which would very badly affect its credit.

Hamilton asserted to justify the lack of the limits in the federal power to tax, and he did so primarily through showing the nature of the constitution. He reminded that the Constitution is written not only for the present time, but also for the generations to come:

*we must bear in mind that we are not to confine our view to the present period, but to look forward to remote futurity.*<sup>49</sup>

Therefore, it cannot be judged based solely on the present context. Because one cannot predict how much the responsibilities to tackle future unknown 'exigencies' (*Federalist* 34, PAH IV: 471-472) will cost, it is impossible to put limits on their ability to raise revenues to pay for those responsibilities:

*Constitutions of civil government are not to be framed upon a calculation of existing exigencies, but upon a combination of these with the probable exigencies of ages, according to the natural and tried course of human affairs.*<sup>50</sup>

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<sup>49</sup> *Federalist* 34, PAH IV: 471.

<sup>50</sup> 'There ought to be a CAPACITY to provide for future contingencies as they may happen; and as these are illimitable in their nature, it is impossible safely to limit that capacity', *Federalist* 34, PAH IV: 472.

Thus, this fiscal capacity cannot be limited to the present needs.<sup>51</sup> The future first Secretary of the Treasury showed that experience teaches us that the cost of conducting wars and fighting rebellions is the biggest expenditure for any government. In his view, the Union would need to 'provide for the protection of the community against future invasions of the public peace, by foreign war or domestic convulsions' (*Federalist* 34, PAH IV: 472). He dismissed those who claimed that they knew how much these responsibilities would cost ('a due provision against probable dangers'), by arguing that they should 'show their data'.<sup>52</sup>

Subsequently, Hamilton demonstrated that even though the US may be a peaceful nation and choose not to fight offensive wars, peace will not always be up to the US to decide, especially in the present context of the European world, with the 'cloud' that may soon turn into a 'storm' and the US could not be totally safe and out of reach from the European powers.<sup>53</sup> Two years later, the French Revolution broke out, so Hamilton was prescient regarding this point. Furthermore, the nature of the economy may bring the US into war with others to protect its trade, 'if we mean to be a commercial people, it must form a part of our policy to be able one day to defend that commerce.' In his conclusion regarding this point, he noted that the national security should remain out of 'political arithmetic'.<sup>54</sup>

The last argument Hamilton discussed in Essay 36 was the fear of poll taxes, which are taxes imposed on every person, regardless of her income. Hamilton admitted

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<sup>51</sup> 'Nothing, therefore, can be more fallacious than to infer the extent of any power, proper to be lodged in the national government, from an estimate of its immediate necessities', *Federalist* 34, PAH IV: 471.

<sup>52</sup> 'We may safely challenge those who make the assertion to bring forward their data and may affirm that they would be found as vague and uncertain as any that could be produced to establish the probable duration of the world', *Federalist* 34, PAH IV: 472.

<sup>53</sup> 'Let us recollect that peace or war will not always be left to our option; that however moderate or unambitious we may be, we cannot count upon the moderation, or hope to extinguish the ambition of others', *Federalist* 34, PAH IV: 473.

<sup>54</sup> 'The support of a navy and of naval wars would involve contingencies that must baffle all the efforts of political arithmetic.', *Federalist* 34, PAH IV: 472.

that he is not in favor of this kind of taxation, but he gave one powerful reason to still give the federal government this possibility. Here again he referred to the potential need to have a ready source of revenue in a state of emergency.<sup>55</sup> He also urged his opponents to distinguish between the possibility and the actuality, or the fact that having a certain power does not mean that this power would be used immediately. In fact, as he reminded his readers, every state government had the power to use these taxes, yet only some of them did so. Paradoxically, those states that use poll taxes themselves are the ones that ‘have uniformly been the most tenacious of their rights’ (*Federalist* 36, PAH IV: 489). Hamilton also used the comparison with the states to dismiss the accusations that connect the fact of having a certain power by the federal government to introducing tyranny:

*Are the State governments to be stigmatised as tyrannies, because they possess this power [of the poll tax]?<sup>56</sup>*

He then asked a rhetorical question by comparing the weight of the accusation against the federal and the state governments, showing the absurdity of the former:

*If they are not, with what propriety can the like power justify such a charge against the national government, or even be urged as an obstacle to its adoption?<sup>57</sup>*

Even some Anti-Federalists such as Federal Farmer agreed on the need to give the federal government unlimited tax power precisely because of the unpredictable threats. As a consequence, Federal Farmer agreed on the need for taxes:

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<sup>55</sup> ‘There are certain emergencies of nations, in which expedients, that in the ordinary state of things ought to be forborne, become essential to the public weal. And the government, from the possibility of such emergencies, ought ever to have the option of making use of them [poll taxes]’, *Federalist* 36, PAH IV: 489.

<sup>56</sup> *Federalist* 36, PAH IV: 489.

<sup>57</sup> *Federalist* 36, PAH IV: 489.

*No society can do without taxes; they are the efficient means of safety and defense, and they too have often been the weapons by which the blessings of society have been destroyed.*<sup>58</sup>

It is worth noting that Federal Farmer demanded two important restrictions in order to protect such ‘blessings of society’. First, before the excises or direct taxes would be levied, the federation must ask states to contribute (and collected the tax themselves), and only when the states fail to do so, the federal government itself may levy those taxes. Second, Federal Farmer also introduced the idea of the states’ veto over federal taxation (which is similar to the idea of the federal veto over states law proposed by Madison during the Philadelphia Convention, but never introduced in the Constitution) expressed not in the Senate, which is a body representing states, but in the state legislatures: if the majority of state assemblies representing a majority of the people would vote that the excise or the direct tax proposed by federation is improper, this federal law would be abandoned.<sup>59</sup>

#### ***4.3.2.3 States will contribute equally based on their wealth, and not on a direct exposure to a threat***

Hamilton recognized that in order to persuade his fellow New Yorkers at the convention to vote for the ratification of the Constitution he had to appeal not only to

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<sup>58</sup> *Federal Farmer: An Additional Number of Letters*, DHRC XX (2): 1004.

<sup>59</sup> ‘However, it is not my object to propose to exclude congress from raising monies by internal taxes, as by duties, excises, and direct taxes; but my opinion is, that congress, especially in its proposed organization, ought not to raise monies by internal taxes, except in strict conformity to the federal plan; that is, by the agency of the state governments in all cases, except where a state shall neglect, for an unreasonable time, to pay its quota of a requisition; and never where so many of the state legislatures as represent a majority of the people, shall formally determine an excise law or requisition is improper, in their next session after the same be laid before them’, *Federal Farmer: An Additional Number of Letters*, DHRC XX (2): 1067-1068.

the common cause and common interest of the Union, but first and foremost had to demonstrate that fiscalization was in their state's interest. He did it by demonstrating that the states failed to comply with the requisitions system even at a time of war, when '[the] pressure of common danger connected strongly the bond of our union' and the federal government's ('incited to vigorous exertions') need for revenues was most obvious.

*we have felt many distressing effects of the impotent system. How have we seen this State [New York], though most exposed to the calamities of the war, complying, in an unexampled manner, with the federal requisitions, and compelled by the delinquency of others, to bear most unusual burdens!*<sup>60</sup>

As a result of 'delinquency' of other states to contribute to the cost of war, New York had to 'bear most unusual burdens'. The states were complying with requisitions only when it was in their interest and Hamilton used the rhetoric of this very interest of a single state to support his claim of a need for fiscalization. A weak state needs a strong federal government, because it would be difficult for such a state to defend itself.<sup>61</sup> A subsequent argument, which he derived from the first one, is that in the system in which a state contributes to the federal treasury when faced with the danger of external military intervention, only the states that would experience war on their territory will fully contribute. Subsequently, he showed that it was the case with New York State in the previous war and, because of its geography, it would likely be the case in future conflicts. Therefore, Hamilton argued, the situa-

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<sup>60</sup> *New York Ratifying Convention. Remarks* (Francis Childs's Version), [20 June 1788], PAH V: 18.

<sup>61</sup> 'This is a weak State; and its relative station is dangerous. Your capital is accessible by land, and by sea is exposed to every daring invader; and on the North West, you are open to the inroads of a powerful foreign nation. Indeed this State, from its situation, will, in time of war, probably be the theatre of its operations.', *New York Ratifying Convention. Remarks* (Francis Childs's Version), [20 June 1788], PAH V: 18.

tion in which New York State contributes the most ('to bear most unusual burdens!') is likely to occur again. From those premises Hamilton drew the conclusion that it is in the interest of New York State that the federal government acquires the power to tax so that all the states would contribute to the common treasury regardless of their current exposure to a threat.

#### *4.3.2.4 Federal responsibilities will be matched with federal resources*

The future Secretary of the Treasury used a comparison with Britain in order to support his argument that the power to tax should be vested at the federal level of government, which would bear the greatest share of public spending. He showed that in Britain, 14 out of 15 of all expenditures were devoted to the common defense, to demonstrate that one should also expect a similar situation to arise in the US. Thus expenditures for defense would constitute the majority of all public expenditures. After asking a rhetorical question about where the power of taxation should be located in this case, he answered that it should be at the level that is responsible for this expensive policy: the federal government.<sup>62</sup> He continued with a more general statement that: 'The Power of Taxation should be coextensive with necessities of Defence'.<sup>63</sup>

Therefore, the government's responsibilities should be adequate to the resources in its possession:

*A government ought to contain in itself every power requisite to the full accomplishment of the objects committed to its care, and to the*

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<sup>62</sup> 'The Genl. Govt. intrusted with that object from whence arise the great source of Expence—Should have the means to support that Expence', *New York Ratifying Convention. Remarks* (JOHN MC KESSON'S VERSION), PAH V: 106.

<sup>63</sup> *New York Ratifying Convention. Remarks*, PAH V: 106.



*complete execution of the trusts for which it is responsible (...).*<sup>64</sup>

If the responsibilities of the government are large, it should have the power over appropriate resources. He further asserted that resources should be both unlimited and beyond the control of other governments. The former characteristic is once again justified by the nature of its purpose: if the purpose of the federal power is potentially unlimited, Hamilton seemed to suggest that even though he did not explicitly write about power to tax, the power over resources cannot be limited either. He himself wrote:

*there ought to be no limitation of a power destined to effect a purpose, which is itself incapable of limitation*<sup>65</sup>.

Hamilton cited this as his maxim, one of the ‘first principles, upon which all subsequent reasonings must depend.’ A Founding Father drew this from ‘ethics and politics’ after presenting the principles that govern geometry, such as that ‘things equal to the same are equal to one another.’ It appears that Hamilton derived the latter characteristic (the lack of external control over its power) from the principle that the new federal government was accountable for its action to the people rather than to the states. Consequently, it should be ‘free from every other control, but a regard to the public good and to the sense of the people. (*Federalist* 31, PAH IV: 458).

#### ***4.3.2.5 The unlimited federal power to tax will paradoxically lead to lower tax rates***

In Essay 35 Hamilton used the type of argument similar to the one he used to justify the federal government’s unlimited power to tax. Remarkably, he took advantage of

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<sup>64</sup> *Federalist* 31, PAH: 457-458.

<sup>65</sup> *Federalist* 31, PAH IV: 456.

the Anti-Federalists' fears of federal taxation in order to justify the unlimited power to tax. Hamilton argued that, paradoxically, in order to control the potentially excessive tax burden of the federal government, the very same federal government would have to be given an extended power of tax. His argument is, in fact, very simple: if the federal government was given the power to raise revenues only from one type of objects, then it is logical that those objects would be inappropriately taxed.<sup>66</sup> As a result of such a high tax burden, he continued, one may observe two phenomena. First, it would cause 'the oppression of particular branches of industry'. Second, it would give rise to an 'unequal distribution of the taxes' (*Federalist* 35, PAH IV: 477) both between the states and between the citizens of the same state.

In order to support his first argument that giving the federal government the right to raise revenue only from import duties would harm some industries while favoring others, Hamilton first repeated his conclusion: the federal government, incapable of raising revenue from a different source, would inevitably establish a dangerously high level of those duties:

*Suppose, as has been contended for, the federal power of taxation were to be confined to duties on imports, it is evident that the government, for want of being able to command other resources, would frequently be tempted to extend these duties to an injurious excess.*<sup>67</sup>

Subsequently, Hamilton dismissed the notion that the rate of duties of import could never be excessively high 'since the higher they are, the more it is alleged they will tend to discourage an extravagant consumption, to produce a favorable balance of trade, and to promote domestic manufactures' (*Federalist* 35, PAH IV: 477). It was

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<sup>66</sup> 'that if the jurisdiction of the national government, in the article of revenue, should be restricted to particular objects, it would naturally occasion an undue proportion of the public burdens to fall upon those objects', *Federalist* 35, PAV IV: 476-477.

<sup>67</sup> *Federalist* 35, PAH IV: 477.

Hamilton's belief that such a conclusion would be incorrect because 'all extremes are pernicious in various ways' and this particular extreme would bring about smuggling, bad for both trade and the revenue. On the one hand, such a high level of custom duties would favor the domestic class of manufacturers, whose products would be cheaper than imported ones, which ultimately would give the manufacturers 'premature monopoly of the markets'; and, on the other, it would disturb the natural composition of the economy. Finally, such high duties would 'oppress the merchant', who would sometimes be forced to cover the duty out of his profit and even his capital, since it is not always possible for the merchant to shift this burden onto the consumer, especially when the supply of goods is high.<sup>68</sup> This is how he explained the first 'evil': limiting federal sources of revenue to duties on imports leads to the oppression of particular branches of industry. The second 'evil' is the unequal burden of taxation on particular states and citizens. He made a distinction between two types of states, those that import and those that manufacture, and subsequently analyzed how the proposed federal duties would affect each type of states.

First, the duty would serve as an additional tax on the consumers in importing states, and the greater the duty, the greater this inequality in contribution to the common treasury would become.<sup>69</sup> Meanwhile, in the case of manufacturing states, a high federal duty would favor those states, since they are able to provide more

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<sup>68</sup> 'When the demand is equal to the quantity of goods at market, the consumer generally pays the duty; but when the markets happen to be overstocked, a great proportion falls upon the merchant, and sometimes not only exhausts his profits, but breaks in upon his capital. (...) It is not always possible to raise the price of a commodity in exact proportion to every additional imposition laid upon it. The merchant, especially in a country of small commercial capital, is often under a necessity of keeping prices down in order to a more expeditious sale', *Federalist* 35, PAH IV: 477.

<sup>69</sup> 'When they are paid by the merchant they operate as an additional tax upon the importing State, whose citizens pay their proportion of them in the character of consumers. In this view they are productive of inequality among the States; which inequality would be increased with the increased extent of the duties', *Federalist* 35, PAH IV: 478.

goods themselves and do not have to import them.<sup>70</sup> This would lead to a situation of great inequality regarding the states' contributions to the federal treasury:

*they [states] would not therefore in this mode alone contribute to the public treasury in a ratio to their abilities.*<sup>71</sup>

This would be the case because some affluent states would not contribute as much as they should. In order to counter this danger, Hamilton proposed the introduction of 'excises', or taxes widely utilized in Britain, which were basically consumption taxes imposed on certain products consumed in the country regardless of their origin.<sup>72</sup> Excises are still common today and are usually imposed on the 'sin goods', such as tobacco or alcohol. Hamilton then made a special call for New York State, since he saw that it would suffer the most from the proposed scheme:

*New York is more deeply interested in these considerations than such of her citizens as contend for limiting the power of the Union to external taxation may be aware of. New York is an importing State, and is not likely speedily to be, to any great extent, a manufacturing State. She would, of course, suffer in a double light from restraining the jurisdiction of the Union to commercial imposts.*<sup>73</sup>

New York would suffer the most from such an arrangement because it was both an importing and non-manufacturing state. Hamilton then argued that even if the excess of duties would not take place, then the inequality among states would none-

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<sup>70</sup> 'farthest towards the supply of their own wants, by their own manufactures, will not, according to their numbers or wealth, consume so great a proportion of imported articles as those States which are not in the same favorable situation.'

<sup>71</sup> *Federalist* 35, PAH IV: 477.

<sup>72</sup> 'To make them do this it is necessary that recourse be had to excises, the proper objects of which are particular kinds of manufactures.'

<sup>73</sup> *Federalist* 35, PAH IV: 478.

theless remain; it would just be present to a lesser degree.

#### 4.3.2.6 *Unlimited power within limited sphere*

Another argument in favor of the federal power to tax lies in the premise that may be called ‘unlimited powers of limited government’ (see also: Epstein 1984: 40-50), i.e. an idea that the federal government has to have limited, clearly described competences, and all of other powers not enumerated in the constitution belong to the states.<sup>74</sup> Nevertheless, within these limited spheres of competence (like wars, foreign affairs, maintaining single market - i.e. abolition of customs duties between states and one custom policy towards third countries, and last but not least, the power of taxation), the power to execute them effectively has to be unlimited. Otherwise, the federation will not serve the purpose it was created for. As Hamilton reminded his fellow citizens:

*in the usual progress of things, the necessities of a nation in every stage of its existence will be found at least equal to its resources.*<sup>75</sup>

However, two Anti-Federalists, Timoleon and Brutus, did not agree with Hamilton on this point. Timoleon argued that from the right of taxation for the purpose of the general welfare one can deduct all other powers that Congress can exercise, because of the principle of law which says that ‘omne majus continet in se minus’ (the greater always contains the less), and the ‘right of *taxing* for the general welfare being the highest and most important mode of providing for it’, all other modes leading to

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<sup>74</sup> *Nota bene*, this constitutional mechanism of the division of power was later copied by other federations, for instance Switzerland (art. 3 of the Swiss Constitution).

<sup>75</sup> *Federalist* 30, PAH IV: 452.

the same end, could be exercised.<sup>76</sup> Brutus also saw the federal tax power as completely unlimited, and the restrictions imposed on this power in the Constitution - artificial, since it will be only the Congress, which will define what constitute such a restriction. Thus, it will be the Congress, which will define what is a 'common defence' and 'general welfare'. States will be left with no power whatsoever in determining such a power of Congress, in his view.<sup>77</sup>

#### 4.3.2.7 *Federal government will be able to act directly on citizens*

An important feature of the new federal government was the ability to act directly on citizens, rather than through the member states: 'to enable the national operate on individuals, in the same manner as those of the states do'.<sup>78</sup>

Hamilton extended this ability to the federal power to tax, where federal government could extract revenues directly from individuals. In his own words:

*As theory and practice conspire to prove that the power of procur-*

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<sup>76</sup> 'The Constitution must be so construed as not to involve an absurdity, which would clearly follow from allowing the end and denying the means. A right of *taxing* for the general welfare being the highest and most important mode of providing for it, cannot be supposed to exclude inferior modes of effecting the same purpose, because the rule of law is, that, omne majus continet in se minus', *Timoleon, New York Journal*, 1 November 1787 (extraordinary), DHRC XIX (1): 167.

<sup>77</sup> 'The legislative power is competent to lay taxes, duties, imposts, and excises;—there is no limitation to this power, unless it be said that the clause which directs the use to which those taxes, and duties shall be applied, may be said to be a limitation: but this is no restriction of the power at all, for by this clause they are to be applied to pay the debts and provide for the common defence and general welfare of the United States; but the legislature have authority to contract debts at their discretion; they are the sole judges of what is necessary to provide for the common defence, and they only are to determine what is for the general welfare: this power therefore is neither more nor less, than a power to lay and collect taxes, imposts, and excises, at their pleasure; not only the power to lay taxes unlimited, as to the amount they may require, but it is perfect and absolute to raise them in any mode they please. No state legislature, or any power in the state governments, have any more to do in carrying this into effect, than the authority of one state has to do with that of another. In the business therefore of laying and collecting taxes, the idea of confederation is totally lost', *Brutus I, New York Journal*, 18 October 1787, DHRC, Volume XIX (1): 107.

<sup>78</sup> *New York Ratifying Convention. Remarks* (Francis Childs's Version), [20 June 1788], PAH V: 19-20.

*ing revenue is unavailing, when exercised over the States in their collective capacities, the Federal government must of necessity be invested with an unqualified power of taxation in the ordinary mode.*<sup>79</sup>

It seems that the fact that the requisition system was ineffective in raising the federal revenue, made it necessary to give the federal government a power to tax citizens directly.

#### ***4.3.2.8 Fiscal needs of the states will diminish, as some of their responsibilities will be shifted to the federal level***

Hamilton again used a comparison with Britain to make his point. He emphasized that in Britain the vast majority of governmental expenses was devoted to military and the same is to be expected in the US. As defense will be the duty of the federal government, there will be large spending disproportion between federal government and states, as the states will no longer need to spend money on military affairs:

*there must always be an immense disproportion between the objects of Federal and State expenditures.*<sup>80</sup>

He then showed that the states will no longer need to incur debt for the war and once the debts of the states from the revolutionary war will be discharged, the the states will need only the revenues to cover a short 'civil list' of obligations, which should not exceed 200.000 pounds.<sup>81</sup> Hamilton then showed that any separation of tax powers, which would give states exclusivity of certain goods, like houses and

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<sup>79</sup> *Federalist* 31, PAH IV: 458.

<sup>80</sup> *Federalist* 34, PAH IV: 474.

<sup>81</sup> 'revenue of any consequence, which the State Governments will continue to experience, will be for the mere support of their respective civil lists; to which, if we add all contingencies, the total amount in every State, ought not to exceed two hundred thousand pounds', *Federalist* 34, PAH IV: 474.

lands, will create ‘a great disproportion between the *means* and the *end*’ (*Federalist* 34, PAH IV: 475), as the needs of the states will be far smaller than before the war, when they had to pay for military affairs. He cited one of the most used distinctions, the one between internal and external taxation, to claim that such a division will create fiscal imbalances. The needs of the federal government will exceed its means - according to Hamilton the states would collect two thirds of the resources to pay for 5-10% of the total expenditures, while the federal government will be left with only one third of revenues to pay for 90-95% of the total expenditures:

*As to the line of separation between external and internal taxes, this would leave to the States at a rough computation, the command of two thirds of the resources of the community, to defray from a tenth to a twentieth part of its expences, and to the Union, one third of the resources of the community, to defray from nine tenths to nineteen twentieths of its expences.*<sup>82</sup>

He interestingly uncovered his thinking about the debt, stating that if federal government would assume the debt, it will make the states dependent on the federal government, and this is exactly what he did when he became the first Secretary of the Treasury under Washington.

*If any fund could have been selected and appropriated, equal to and not greater than the object, it would have been inadequate to the discharge of the existing debts of the particular States, and would have left them dependent on the Union for a provision for this purpose.*<sup>83</sup>

He concluded his point that ‘any separation of the objects of revenue’ will lead to the subordination of states for the union (*Federalist* 34, PAH IV: 476). Therefore, the

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<sup>82</sup> *Federalist* 34, PAH IV: 475 (spelling in original).

<sup>83</sup> *Federalist* 34, PAH IV: 476.



common, concurrent power over object of taxation is the best way to ensure ‘indefinite constitutional power of taxation in the Federal government with an adequate and independent power in the States to provide for their own necessities.’ (*Federalist* 34, PAH IV: 476).

#### ***4.3.2.9 Federal taxes will have a natural limit against excess***

Hamilton argued for excise taxes as a better option than property taxes, because of their natural limitation against excessive burden. This security lies in a voluntary character of these taxes - if one finds prices of certain goods too high, because of the excessive tax, one may choose not to buy them. If the tax will be moderate, then nobody would bother to smuggle or to avoid buying it because of the high price. Hamilton knew that increasing the tax rate is not equal to the increase of the revenue, in his words:

*in political arithmetic, two and two do not always make four.*<sup>84</sup>

In this sense excise taxes are similar to the impost, because both of them are indirect - they are included in the price of the good, and therefore are voluntary (as long as the so called ‘necessities’ of life are not taxed). Hamilton in these remarks seemed to be anticipating the Laffer curve, which shows that increasing the tax rate will increase tax revenues only to a certain point, and after passing a certain threshold every unit of tax rate increase will diminish the total tax revenues.

Remarkably, the argument that the federal taxes will have a natural limit against

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<sup>84</sup> *Federalist* 21, PAH IV: 400f.

excess was shared also by the Anti-Federalists, who regarded the impost (custom duty) as the most proper tax to be granted for the federal government due to the nature of this tax:

*But few officers are necessary to be employed in collecting them, and there is no danger of oppression in laying them, because, if they are laid higher than trade will bear, the merchants will cease importing, or smuggle their goods. We have therefore sufficient security, arising from the nature of the thing, against burdensome, and intolerable impositions from this kind of tax.<sup>85</sup>*

Brutus admitted that the government would try to impose excessive rate of this tax, a decrease of revenue will result as a consequence of smuggling or a decrease in consumption. The impost was favored also for practical reasons - its collection required a very few tax officers.

#### ***4.3.2.10 Fiscalization will lead to a more democratic government***

It was the common knowledge, shared by both the Federalists and the Anti-Federalists, that the system of financing the Union, which existed under the Articles of Confederation, had failed. This led to an agreement shared by both groups, that the new federal government needs an independent source of revenue. However, while the Federalist argued that such source should be unlimited, the Anti-Federalists maintained that the power over impost will suffice. Nevertheless, once the necessity of the federal independent source of revenue was widely accepted, it

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<sup>85</sup> Brutus V, New York Journal, 13 December 1787, DHRC XIX (1): 415.

was used by the Federalists to achieve two goals. First, to extend this power in order to include other types of taxes, on the basis that it is impossible to assume that the impost will forever provide enough revenues for the federal government to cover its responsibilities, especially when faced with threats. Secondly, and perhaps more importantly, this virtually unlimited power to tax was used as a powerful tool in their rhetoric to justify the creation of the entire new system of government.

Once the Federalists convinced their opponents that the federal power tax is necessary, they argued that such a great power could not be vested into a single body, i.e. the Congress, as it was the case under the Articles of Confederation. Instead, the new Congress would need to be 'checked and balanced' by other branches of government - strong federal executive and judiciary. Moreover, the legislative branch should be further divided between two chambers: the Senate, and the House of Representatives. The former was supposed to resemble the Confederation Congress with its one state – one vote rule; in the Senate each state would have two senators regardless of its population, which reflected a principle of federalism, while the election to the latter was based on the population of each state and reflected the principle of democracy. Therefore, the very federal power to tax, that the Federalists were so fiercely advocating for, was then used by them, to justify the creation of an entirely new system of government by using the Anti-Federalists' fears of a strong and unaccountable federal government.

Paradoxically, once this idea of federal power to tax was accepted, the Federalists used it in order to convince others that such a strong power (and Americans knew how strong such a power is, since they started a revolution precisely because of unjust taxes imposed on them without their consent) should not be delegated to a single body, the Confederation Congress. The Federalists did so by playing on the fears of excessive taxation imposed by remote government without their consent, the fears that were so common in America since the Revolutionary War. They could not have done so without the common knowledge that the previous system of requi-

sitions was a failure and that there was a strong need to provide federal government with independent source of revenue. And this knowledge became common as a result of a threat resulting from the sovereign debt crisis in the states and especially Shays's Rebellion.

As a consequence, the common agreement of the need to give federal government some fiscal power provided the Federalists with a good justification for the new system of government based on 'checks and balances' between its federal branches. Indeed, Hamilton, did exactly this: in his speech at New York's ratifying convention, he linked the unlimited federal power of taxation with the new design of the government. This is cited in length in order to show how one change required the other:

*Though we might give to such a government certain powers with safety, yet to give them the full and unlimited powers of taxation and the national forces would be to establish a despotism; the definition of which is, a government, in which all power is concentrated in a single body. To take the Old Confederation, and fashion it upon these principles, would be establishing a power which would destroy the liberties of the people. These considerations show clearly, that a government totally different must be instituted. They had weight in the convention that formed the new system. It was seen, that the necessary powers were too great to be trusted to a single body: They therefore formed two branches; and divided the powers, that each might be a check upon the other.<sup>86</sup>*

The future Secretary of the Treasury admitted that such a power is very substantial and could be dangerous for the 'liberties of the people'. It is for this very reason that there had to be a dramatic change in the structure of government. He very skillfully used the fears of the consequences of adopting one measure - federal power to tax,

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<sup>86</sup> New York Ratifying Convention. Remarks (Francis Childs's Version), [20 June 1788], PAH V: 20.

to justify the implementation of another measure: three branches of the federal government. As soon as everybody agreed on the need for such a federal power to tax, it became easy to argue for the extension of federal institutions whose branches will check and balance each other. Ironically, it was done by using the arguments of the Anti-Federalists, that is - the fears of the excessive use of this tax, to convince the people that completely new system of government should be established.

To sum up, in this section I presented the following arguments that concerned the positive consequences of fiscalization of the federal government:

1. Federal credit and the ability to borrow at low rates;
2. A possibility to tackle future unpredictable exigencies: A Constitution written for centuries, not decades;
3. States will contribute equally based on their wealth, and not on a direct exposure to a threat;
4. Federal responsibilities will be matched with federal resources;
5. The unlimited federal power to tax will paradoxically lead to lower tax rates;
6. Unlimited power within a limited sphere;
7. The federal government will be able to act directly on citizens;
8. The fiscal needs of the states will diminish, as some of their responsibilities will be shifted to the federal level;
9. Federal taxes will have a natural limit against excess;
10. Fiscalization will lead to a more democratic government.

In this group there is a strong presence of a threat factor, which confirms to a large extent my hypothesis as outlined in Chapter 2.4. Two important arguments touched upon a threat directly. Firstly, an idea that fiscalization would provide a possibility to tackle unpredictable exigencies that the Union will have to confront in the future. This idea was linked to the strong commitment of the Framers that the Constitution

has to be written for centuries, and not decades, which means that in calculating the needed amount of fiscal resources of the federal government one cannot rely on the present-day needs, as some threats or challenges will inevitably emerge only in the future.

Secondly, it was argued that fiscalization would lead to the fair contributions to the federal budget. While a system of calculating a fair share did exist under the requisition system, and in theory the states were obliged to contribute based on those calculations, in practice only those states which were most exposed to a threat of war did so. This implied that that states which had to fight a war contributed the most, while others had a free ride on their expense. Fiscalization was meant to fix that, as the states (or rather - citizens or firms of those states) would pay their equal share to the federal budget based on their wealth, and not on a (direct) exposure to a threat.

The other arguments of this group were more or less directly connected with the previous two 'threat' arguments. For instance, the ability of the federal government to tackle future unpredictable exigencies will be made possible by several other consequences of fiscalization that were presented during the ratification. For instance, the fact that fiscalization will allow the government to borrow cheaply and tax citizens directly, albeit lightly. Moreover, such unlimited power would not be abused due to the specific nature of the major envisioned federal tax - a custom duty. The fact that such a change in fiscal governance would be accompanied with the change of political governance (and so the people and the states would be properly represented at the federal level), as well as the fact that this power, while being virtually unlimited, is confined to a limited sphere guaranteed that the liberties of people will not be abused. Such a fiscal sphere would allow the federal government to pay for its responsibilities. When it comes to the state-federal relations, the former level of government had nothing to fear from the emergence of fiscalization, as

their responsibilities will diminish and so will their fiscal needs. The arguments favoring federal power to tax, however, did not convince everybody as I show in the following section on the negative consequences of fiscalization.

### ***4.3.3 The negative consequences of fiscalization of the federal government***

#### ***4.3.3.1 The states would be left with no money, since federal government would collect all the taxes***

Hamilton countered the argument that the federal power to tax would cause the states to vanish fiscally, maintaining that:

*in all matters of taxation, except in the article [in the case] of imposts, the united and individual states had a concurrent jurisdiction; that the state governments had an independent authority, to draw revenues from every source but one.<sup>87</sup>*

Therefore, according to Hamilton, both the states and the federal government have equal power over every source of revenue, with only one exception: the impost, which is a source reserved only for the federal level of government. He then used the general principle of residual power which is vested in the states and ‘that whatever is not expressly given to the federal head, is reserved to the members’,<sup>88</sup> to show that the fears that states would be left without any source of revenue are unwarranted. In Hamilton’s view, even though the Constitution gives a certain source of revenue to the federation, it does not reserve them for the federation. He used the only exception, the impost, to make his point: if all the sources were reserved for the federation, then the Constitution would not have prohibited the states from levying impost. This prohibition is provided in Section 10, article 1, which reads as follow:

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<sup>87</sup> *New York Ratifying Convention. Third Speech of June 28 (FRANCIS CHILDS’S VERSION)*, PAH V: 116.

<sup>88</sup> *New York Ratifying Convention. Third Speech of June 28 (FRANCIS CHILDS’S VERSION)*, PAH V: 117.



‘No State shall, without the Consent of the Congress, lay any Imposts or Duties on Imports or Exports.’

Hamilton also responded to the criticism that the federal government would have the right to collect its taxes first, and so later nothing would be left to the states. In this context, he used the comparison between two creditors who have an equal right to demand a payment from a debtor. Similarly, the two levels of government would have the same equal right over the taxpayer.<sup>89</sup> It was his prediction that the majority, specifically at least two-thirds, of the resources would still go to the states. Hamilton claimed that:

*Now, what proportion will the duties on imports bear to the other ordinary resources of the country? We may now say, one third; but this will not be the case long. As our manufactures increase, foreign importations must lessen. Here are two thirds at least of the resources of our country open to the state governments. Can it be imagined then, that the states will lose their existence or their importance for want of revenues?<sup>90</sup>*

By demonstrating that the federal government would use only one-third of the total revenues, Hamilton tried to fend off accusations that the states would become powerless and left with no money. Next, he argued that such a provision is necessary because the federal government must pay off its debts: ‘to pledge as a fund for the reduction of the debts of the United States.’<sup>91</sup> As a result, this federal burden would not fall on the states. For this specific purpose, Hamilton formulated a statement that may well be considered to be a motto of this provision:

*When you have given a power of taxation to the general government,*

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<sup>89</sup> *New York Ratifying Convention. Third Speech of June 28 (FRANCIS CHILDS’S VERSION)*, PAH V: 116.

<sup>90</sup> *New York Ratifying Convention. Third Speech of June 28 (FRANCIS CHILDS’S VERSION)*, PAH V: 117.

<sup>91</sup> *New York Ratifying Convention. Third Speech of June 28 (FRANCIS CHILDS’S VERSION)*, PAH V: 117.

*none of the states individually will be holden for the discharge of the federal obligations: The burthen will be on the union.*<sup>92</sup>

Federal Farmer also agreed on the need of federal impost, which will be adequate to the 'present demand of the union'. Moreover, the revenues from them will probably increase, because the impost rates will be uniformed throughout the country. However, he was reluctant to give the Union the power over internal taxes because of the states' large amount of debt, which would have to be paid back.<sup>93</sup> Subsequently, Federal Farmer maintained that the states should have the exclusive right to raise some internal taxes: 'as the states owe large debts, and have large demands upon them individually.'<sup>94</sup> Such a demand would reflect the exclusivity of the federal government in the impost.

After discussing the two main objections of the opponents of the federal power to tax, Hamilton proceeded to present his counterarguments. The first objection is that 'an indefinite power of taxation in the *latter* [the Union] might, and probably would in time deprive the *former* [the states] of the means of providing for their own necessities; and would subject them entirely to the mercy of the national Legislature' (*Federalist* 31, PAH IV: 458-459). Therefore, the argument is that the unlimited power of federal taxation would take over the entire tax base and the states would be left with no money, as everything taxable would already have been taxed by the

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<sup>92</sup> *New York Ratifying Convention. Third Speech of June 28 (FRANCIS CHILDS'S VERSION)*, PAH V: 117.

<sup>93</sup> 'By giving the union power to regulate commerce, and to levy and collect taxes by imposts, we give it an extensive authority, and permanent productive funds, I believe quite as adequate to the present demands of the union, as excises and direct taxes can be made to the present demands of the separate states. The state governments are now about four times as expensive as that of the union; and their several state debts added together, are nearly as large as that of the union—Our impost duties since the peace have been almost as productive as the other sources of taxation, and when under one general system of regulations, the probability is, that those duties will be very considerably increased', *Federal Farmer: An Additional Number of Letters to the Republican*, New York, 2 May 1788, DHRC XX (2): 1067.

<sup>94</sup> 'As the states owe large debts, and have large demands upon them individually, there clearly would be a propriety in leaving in their possession exclusively, some of the internal sources of taxation, at least until the federal representation shall be properly encreased (...)', *Federal Farmer, Letters to the Republican*, 8 November 1787, DHRC, Volume XIX (1): 226.

federal government. The second reservation is related to the first one, but its focus is on the clause of the Constitution according to which the 'Laws of the Union (...) shall be the supreme law of the land'. This was connected with the clause stating that federal government would 'have power to pass all laws that may be NECESSARY for carrying into execution the authorities with which it is proposed to vest it.' As a consequence, this gives the federal government the possibility to 'at any time abolish the taxes imposed for State objects upon the pretense of an interference with its own' (*Federalist* 31, PAH IV: 459). However, Hamilton declared that the states would remain fiscally independent and that the federal government would not legally be able to restrict 'uncontrollable authority to raise their own revenues for the supply of their own wants' (*Federalist* 32, PAH IV: 461).

In Essay 32, Hamilton continued to present arguments against the idea of the Anti-Federalists that the 'anger of the consequences, which seem to be apprehended to the State Governments, from a power in the Union to controul them in the levies of money' (*Federalist* 32, PAH IV: 461, spelling in original), which he presented in the previous essay. He once again argued that there is no danger that the federal power to tax would endanger similar power at the state level. He first dismissed the idea on the grounds that the 'sense of the people' and the 'hazard of provoking the resentments of the State governments' would constitute a 'complete barrier against the oppressive use of such a power' (*Federalist* 32, PAH IV: 461). He agreed with his opponents and consequently admitted on:

*the justness of the reasoning, which requires that the individual States should possess an independent and uncontrollable authority to raise their own revenues.*<sup>95</sup>

Hamilton presented his arguments to support a statement that apart from the im-

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<sup>95</sup> *Federalist* 32, PAH IV: 461.

post on imports (which is exclusively delegated to the federal government) and exports (which are banned altogether for both the states and the Union), the states would 'retain that authority in the most absolute and unqualified sense' (*Federalist* 32, PAH IV: 461).

Hamilton reminded his readers that 'an attempt on the part of the national government to abridge them in the exercise of it, would be a violent assumption of power, unwarranted by any article or clause of its Constitution' (*Federalist* 32, PAH IV: 461). The Union created by the Constitution is 'a partial union or consolidation' and does not subordinate the states into 'one complete national sovereignty' (*Federalist* 32, PAH IV: 461). Instead, the states would 'retain all the rights of sovereignty which they before had' with the only exemption for the rights that in the Constitution 'EXCLUSIVELY delegated to the United States.'

Hamilton laid out three cases of such an exclusivity of the federal government. First, 'where the Constitution in express terms granted an exclusive authority to the Union.' An example of this would be the sole federal legislative authority over the district that would become federal capital (now known as the District of Columbia). Hamilton's second case of federal exclusivity is 'where it granted in one instance an authority to the Union, and in another prohibited the States from exercising the like authority' which is the most important one for this study. Hamilton further elaborated on this point to show how the Constitution grants the exclusive right to the federal government over duties of imports, prohibits the states from levying such duties and bans all levels of the government from levying the duties on export. This clause resulted from the lobbying of the Southern states, which feared that the federal government would use such a power to tax the tobacco, indigo rice or cotton, the products they these states were exporting.<sup>96</sup> Third, 'where it granted an authori-

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<sup>96</sup> Empowers Congress 'TO LAY AND COLLECT TAXES, DUTIES, IMPOSTS AND EXCISES'; and the second clause of the tenth section of the same article declares that, 'NO STATE SHALL, without the consent of Congress, LAY ANY IMPOSTS OR DUTIES ON IMPORTS OR EXPORTS, except for

ty to the Union, to which a similar authority in the States would be absolutely and totally *contradictory* and *repugnant*' - here he did not refer to the nature of the right granted to the federal government. Hamilton gave example of the 'power to establish an UNIFORM RULE of naturalization throughout the United States', which by nature has to be just one.

Next, Hamilton lectured on the legal explanation of the fact that all other taxes on both exported and imported goods are 'concurrent and coequal authority in the United States and in the individual States.' He explained why there is no confirmation of such powers in the Constitution, using the legal term of 'NEGATIVE PREGNANT that is, a *negation* of one thing, and an *affirmance* of another' (capitals and italics in original), showing that a negation of the states' power to tax imported or exported goods is at the same time a confirmation of their rights to tax all other goods. He then introduced the idea of divided sovereignty, explaining that such a concurrent authority is a consequence of this division: 'The necessity of a concurrent jurisdiction in certain cases results from the division of the sovereign power' (*Federalist* 32, PAH IV: 464).

Hamilton started his Essay 34 by asserting his reader once again that the states would have enough revenues ('means as abundant as could be desired') to cover 'for the supply of their own wants', they would only be exerted from the duties on imports and exports, and the remaining sources of revenue would be shared with the federal government and their tax power would be 'independent of all external control.' Thus, the Constitution will guarantee the states' right to use all kind of taxes but the impost. Moreover, those other taxes will provide the states a majority of the revenues: 'leaves open to the States far the greatest part of the resources of the

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the purpose of executing its inspection laws.' Hence would result an exclusive power in the Union to lay duties on imports and exports, with the particular exception mentioned; but this power is abridged by another clause, which declares that no tax or duty shall be laid on articles exported from any State; in consequence of which qualification, it now only extends to the DUTIES ON IMPORTS.', *Federalist* 32, PAH IV: 462.

community'. The fact that, Hamilton seemed to argue, the federal government would assume most of the responsibilities, a common defense, which is now a responsibility of the states' budgets, would diminish their fiscal needs ('the wants of the States will naturally reduce themselves within A VERY NARROW COMPASS' and with 'inconsiderable share of the public expenses for which it will fall to the lot of the State governments to provide', *Federalist* 34, PAH IV: 470). Hence, the resource which states would be able to tax would give them even more revenues than they will need.

The second argument of Essay 34 against this kind of power is that it would lead to the 'interference between the revenue laws of the Union and of the particular States' (the 'power of internal taxation in the national legislature could never be exercised with advantage,(...) as from an interference between the revenue laws of the Union and of the particular States' (*Federalist* 36, PAH IV: 484). The future Secretary of the Treasury then discussed in detail this interference of the law. His argument is that 'there can be no clashing or repugnancy of authority' (*Federalist* 36, PAH IV: 487), and legally the revenue laws of two level of governments cannot 'interfere with each other.' He envisioned the idea that every level should abstain from taxing objects that were previously taxed by another level, that they should 'abstain from those objects, which either side may have first had recourse to' (*Federalist* 36, PAH IV: 487). Hamilton advanced the idea that both levels of government, the Union and the states, would have a mutual interest in 'reciprocal forbearance' because 'neither can controul the other' (*Federalist* 36, PAH IV: 487). Thus, this mutual interest is the best guarantee that this system will work.<sup>97</sup>

By contrast, Brutus claimed that the federal tax power would leave the states with

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<sup>97</sup> 'As to the interference of the revenue laws of the Union, and of its members, we have already seen that there can be no clashing or repugnancy of authority. The laws cannot, therefore, in a legal sense, interfere with each other; and it is far from impossible to avoid an interference even in the policy of their different systems', *Federalist* 36, PAH IV: 487.

no money:

*Every one who has thought on the subject, must be convinced that but small sums of money can be collected in any country, by direct taxes, when the fœderal government begins to exercise the right of taxation in all its parts, the legislatures of the several states will find it impossible to raise monies to support their governments. Without money they cannot be supported, and they must dwindle away, and, as before observed, their powers absorbed in that of the general government.*<sup>98</sup>

Similarly, Federal Farmer warned ‘that the general government may suspend a state tax’ because of the fact that ‘both [layers of government] may tax the same objects in the same year.’<sup>99</sup> He further remarked that: ‘A power to lay and collect taxes at discretion, is, in itself, of very great importance’, because with such power ‘government may command the whole or any part of the subject’s property.’<sup>100</sup>

Federal Farmer, just as Hamilton, also made a distinction between external and internal taxes. He wrote that the former are the impost duties on imported goods and can easily be collected in a few ports by a limited number of tax officers and have a natural limit of excess.<sup>101</sup>

A quite different matter is with internal taxes, by which he understood ‘poll and land taxes, excise, duties on all written instruments, &c. [etc.] may fix themselves on

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<sup>98</sup> *Brutus I, New York Journal*, 18 October 1787, DHRC, Volume XIX (1):108.

<sup>99</sup> ‘Further, as to internal taxes, the state governments will have concurrent powers with the general government, and both may tax the same objects in the same year; and the objection that the general government may suspend a state tax, as a necessary measure for the promoting the collection of a federal tax, is not without foundation.’ *Federal Farmer, Letters to the Republican*, 8 November 1787, DHRC, Volume XIX (1): 226.

<sup>100</sup> *Federal Farmer, Letters to the Republican*, 8 November 1787, DHRC XIX (1): 224.

<sup>101</sup> ‘they can be carried no higher than trade will bear, or smuggling permit’, *Federal Farmer, Letters to the Republican*, 8 November 1787, DHRC, Volume XIX (1): 224.

every person and species of property in the community'<sup>102</sup>, as they do not inherit limits against excessive use and require a vast number of tax collectors. The last point being especially pertinent in the US because of its vast territory. Federal Farmer also warned against the large number of federal laws required for the purpose of such taxation, which 'must continually interfere with the state laws, and thereby produce disorder and general dissatisfaction, till the one system of laws or the other, operating upon the same subjects, shall be abolished.' As a consequence, they 'will probably soon defeat the operations of the state laws and governments'<sup>103</sup>.

Federal Farmer noted the ambiguity of some tax provisions. For instance, he was not convinced that the appropriation requirement of Article 1, Section 2 of the Constitution means, as some believed, that this clause supports the idea that Congress would still ask states for requisitions when it comes to the direct taxation, however the following clause in section 8 seems to be in contradiction to such a statement.<sup>104</sup> It reads as follows: 'The Congress shall have Power To lay and collect Taxes, Duties, Imposts and Excises, to pay the Debts and provide for the common Defense and general Welfare of the United States; but all Duties, Imposts and Excises shall be uniform throughout the United States'.

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<sup>102</sup> *Federal Farmer, Letters to the Republican*, 8 November 1787, DHRC XIX (1): 224-225.

<sup>103</sup> *Federal Farmer, Letters to the Republican*, 8 November 1787, DHRC XIX (1): 225.

<sup>104</sup> 'There appears to me to be not only a premature deposit of some important powers in the general government—but many of those deposited there are undefined, and may be used to good or bad purposes as honest or designing men shall prevail. By Art. 1, Sect. 2, representatives and direct taxes shall be apportioned among the several states, &c.—same art. sect. 8, the Congress shall have powers to lay and collect taxes, duties, &c. for the common defence and general welfare. but all duties, imposts and excises, shall be uniform throughout the United States: By the first recited clause, direct taxes shall be apportioned on the states. This seems to favour the idea suggested by some sensible men and writers, that Congress, as to direct taxes, will only have power to make requisitions; but the latter clause, power to tax immediately individuals, without the intervention of the state legislatures[.] in fact the first clause appears to me only to provide that each state shall pay a certain portion of the tax, and the latter to provide that Congress shall have power to lay and collect taxes, that is to assess upon, and to collect of the individuals in the state, the states quota; but these still I consider as undefined powers, because judicious men understand them differently' *Federal Farmer, Letters to the Republican*, 8 November 1787, DHRC XIX (1): 231.



#### 4.3.3.2 *The federal government would use the money raised to oppress the people and repress their liberties*

Hamilton confronted the principal argument of the Anti-Federalists, which concerned the potential usurpation of the federal government. He stressed that a danger of usurpation is equal on the state level, which has unlimited power in every aspect of politics. However, neither the nature nor the extent of this power should be the focus point of the people concerned with usurpation. Rather, the structure of the government should - the states enjoy 'complete sovereignty' and so usurpation may more easily come from 'that quarter'.<sup>105</sup> Thus, he then turned this argument on its head and warned that the states could encroach on the powers vested in federation more easily, and because the states are closer to the people, it would always be harder for the federation to resist such encroachments. He hoped that the people would make sure that a 'constitutional equilibrium' between two levels of governments is maintained.<sup>106</sup>

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<sup>105</sup> 'Observations founded upon the danger of usurpation ought to be referred to the composition and structure of the government, not to the nature or extent of its powers. The State governments, by their original constitutions, are invested with complete sovereignty. In what does our security consist against usurpation from that quarter? Doubtless in the manner of their formation, and in a due dependence of those who are to administer them upon the people', *Federalist* 31, PAH IV: 459.

<sup>106</sup> 'It should not be forgotten that a disposition in the State governments to encroach upon the rights of the Union is quite as probable as a disposition in the Union to encroach upon the rights of the State governments. What side would be likely to prevail in such a conflict, must depend on the means which the contending parties could employ toward insuring success. As in republics strength is always on the side of the people, and as there are weighty reasons to induce a belief that the State governments will commonly possess most influence over them, the natural conclusion is that such contests will be most apt to end to the disadvantage of the Union; and that there is greater probability of encroachments by the members upon the federal head, than by the federal head upon the members. But it is evident that all conjectures of this kind must be extremely vague and fallible: and that it is by far the safest course to lay them altogether aside, and to confine our attention wholly to the nature and extent of the powers as they are delineated in the Constitution. Every thing beyond this must be left to the prudence and firmness of the people; who, as they will hold the scales in their own hands, it is to be hoped, will always take care to preserve the constitutional equilibrium between the general and the State governments. Upon this ground, which is evidently the true one, it will not be difficult to obviate the objections which have been made to an indefinite power of taxation in the United States', *Federalist* 31, PAH IV: 460.

Then, Hamilton discussed an argument that this kind of power ‘could never be exercised with advantage’ because of the lack of ‘sufficient knowledge of local circumstances’ within the federal Congress’ (*Federalist* 36, PAH IV: 484).

His rejection of this argument results from the fact that the arguments of his opponents are ‘destitute of foundation.’ Specifically, he compared relations between a state and the Union, to the relationship between a state and its counties. Hamilton then asked a rhetorical question: ‘If any question is depending in a State legislature respecting one of the counties, which demands a knowledge of local details, how is it acquired?’ He immediately proceeded to give the answer: ‘No doubt from the information of the members of the county.’ He wanted to suggest that the same logic could easily be applied to the members of the national legislature; they could obtain information about particular states from the members of these states (‘Cannot the like knowledge be obtained in the national legislature from the representatives of each State?’ (*Federalist* 36, PAH IV: 484). Next, Hamilton reminded his readers that ‘the knowledge of local circumstances, as applied to taxation’ is not a detailed knowledge of every single aspect of states’ geography (‘a minute topographical acquaintance with all the mountains, rivers, streams, highways, and bypaths in each State’). Instead, it is ‘a general acquaintance’ with the nature of the economy of each state, ‘with its situation and resources.’<sup>107</sup>

Hence, with the help of their colleagues from relevant states the members of the national legislature would be able to understand the circumstances of those states. This is also partly because these men would have a ‘degree of intelligence’ above the average:

*And is it not to be presumed that the men who will generally be sent*

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<sup>107</sup> ‘with the state of its agriculture, commerce, manufactures, with the nature of its products and consumptions, with the different degrees and kinds of its wealth, property, and industry’, *Federalist* 36, PAH IV: 484.

*there will be possessed of the necessary degree of intelligence, to be able to communicate that information [on the circumstances of relevant states]?*<sup>108</sup>

Hamilton further supported his point by claiming that the general knowledge of the 'situation and resources' of the states would be sufficient for the tax policy making on the federal level. Then he claimed that before a tax law is passed to the parliament, a draft is prepared by one individual or a committee of a few men. Such 'inquisitive and enlightened' men are perceived to be 'best qualified to make a judicious selection of the objects proper for revenue everywhere'. Therefore, he seemed to suggest, 'as far as the sense of mankind can have weight in the question', it supports his argument regarding knowledge of local circumstances.

There would be no difficulties with regards to 'duties and excises on articles of consumption'. In his opinion, knowledge of the articles would be usually enough to learn about the characteristic of these indirect taxes, and it would be usually uniform across the states. The main issue here would be to avoid taxing objects by the federal government, which had previously been taxed by the states. By contrast, he considered the taxes on 'real property or (...) houses and lands' as more problematic direct taxes (*Federalist* 36, PAH IV: 485). With regards to the land taxes, which can be imposed by using the 'ACTUAL valuations' or by 'OCCASIONAL assessments,' the purpose of law is to provide 'general principles.'<sup>109</sup> Therefore, the lawmakers would not need a detailed knowledge of the land markets in each state. This could be done without any difficulties in the national parliament, just as it is done in a

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<sup>108</sup> *Federalist* 36, PAH IV: 484.

<sup>109</sup> 'All that the law can do must be to name the persons or to prescribe the manner of their election or appointment, to fix their numbers and qualifications and to draw the general outlines of their powers and duties,' *Federalist* 36, PAH IV: 486.

state legislature.<sup>110</sup> In fact, a detailed knowledge of the land markets, their values, etc., would be necessary only for those who will execute the law, the ‘commissioners or assessors.’<sup>111</sup>

In laying and collecting the above-mentioned taxes, such as the taxes on real estate, the federal government could use the same methods in which a given state levied such a tax. In Hamilton’s own words: ‘The national legislature can make use of the system of each state within that state’ (*Federalist* 36, PAH IV: 487). He further specified that:

*The method of laying and collecting this species of taxes in each State can, in all its parts, be adopted and employed by the federal government.*<sup>112</sup>

The Constitution put two important limits on the Congressional power to levy direct taxes, which ‘guarded circumspection’ against the ‘abuse of this power of taxation’ (*Federalist* 36, PAH IV: 486). The first such limit is the apportionment rule with its three-fifths clause, which says that the direct taxes would be apportioned (or distributed proportionally) according to the number of its citizens, while every slave would be counted as three-fifth of a free person. This famous clause was introduced in the Constitution for political reasons, in order to convince the Northern states to accept the rule that slaves would be counted in the assessment of the number of each state’s representation in the House of Representatives. The Federalists used the argument that it is fair that Southern states would be overrepresented in the House due to their large populations of slaves, because the three-fifths rule would also apply to the proportioning of the amount of direct taxes that would be collected in

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<sup>110</sup> ‘And what is there in all this, that cannot as well be performed by the National Legislature as by a State Legislature?’, *Federalist* 36, PAH IV: 486.

<sup>111</sup> ‘the EXECUTION of the business, which alone requires the knowledge of local details, must be devolved upon discreet persons in the character of commissioners or assessors’, *Federalist* 36, PAH IV: 487.

<sup>112</sup> *Federalist* 36, PAH IV: 487.

each state for the common purpose of the federal treasury. However, nobody really expected that direct taxes would be used. Indeed, until the Civil War the direct taxes were used only exceptionally (Woźniakowski and Steinmo 2018).<sup>113</sup>

This rule of proportioning the amount of taxes to be levied for federal government in each state, based on the population of this state, ‘effectually shuts the door to partiality or oppression’ (*Federalist* 36, PAH IV: 486). That notwithstanding, Hamilton failed to address the issue that this principle could lead to a situation in which the populous yet poor states would have to pay more than small but rich ones. The second firewall against the abuse of the federal power of direct taxation is the uniformity rule, which states that ‘all duties, imposts, and excises shall be UNIFORM throughout the United States’ (*Federalist* 36, PAH IV: 486).

Furthermore, Hamilton discussed the federal government’s possibilities for asking the states for contributions, or requisitions, if the new system would prove to be ‘really inconvenient’ (‘exercise of the power of internal taxation by the Union should be discovered on experiment to be really inconvenient’ (*Federalist* 36, PAH IV: 486). Even though such a possibility should exist, the federation should not rely on requisition and should ‘omit that ambiguous power’ [of internal taxation] as opponents of the Constitution charged. Next, he provided two arguments in favor of internal taxation. First, the internal taxation would be ‘more effectual’ and it is more probable that it would be ‘advantageously exercised’ and only applying it in practice, or conducting ‘experiment[s]’ could show that this is the case. Second, the very possibility of having the power of an independent source of revenue would give a strong signal to the states that would be more prompt and willing to provide the

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<sup>113</sup> ‘Representatives and direct Taxes shall be apportioned among the several States which may be included within this Union, according to their respective Numbers, which shall be determined by adding to the whole Number of free Persons, including those bound to Service for a Term of Years, and excluding Indians not taxed, three fifths of all other Persons’, *Constitution of the United States*, art. 1, sec. 2.

necessary funds when asked, which was not the case under the Articles where the Congress relied exclusively on the states.<sup>114</sup>

Federal Farmer, on the other hand, claimed that the Constitution does not give the states any check on the power of Congress to tax, and only the people, as the ultimate sovereign, can protest against it (and only protest, one could add, as the people has no formal power other than that):

*Two taxing powers may be inconvenient; but the point is, congress, like the senate of Rome, will have taxing powers, and the people no check—when the power is abused, the people may complain and grow angry, so may the state governments; they may demonstrate and counteract, by passing laws to prohibit the collection of congressional taxes; but these will be acts of the people, acts of sovereign power, the dernier resort unknown to the constitution; acts operating in terrorum, acts of resistance, and not the exercise of any constitutional power to stop or check a measure before mature.*<sup>115</sup>

Furthermore, Federal Farmer raised the argument that federal tax power would not be limited solely to those taxes enlisted in the Constitution (‘By art. 1. sect. 8. congress will have power to lay and collect taxes, duties, imposts and excise.’), but as he wrote: ‘(t)his congress will clearly have power to lay and collect all kind of taxes whatever—taxes on houses, lands, polls, industry, merchandize, &c.—taxes on deeds, bonds, and all written instruments—on writs, pleas, and all judicial proceedings, on licences, naval officers papers, &c. on newspapers, advertisements’.<sup>116</sup>

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<sup>114</sup> ‘existence of such a power in the Constitution will have a strong influence in giving efficacy to requisitions. When the States know that the Union can apply itself without their agency, it will be a powerful motive for exertion on their part’, *Federalist*, PAH IV: 487.

<sup>115</sup> *Federal Farmer: An Additional Number of Letters to the Republican*, New York, 2 May 1788, DHRC XX (2): 1007.

<sup>116</sup> *Federal Farmer: An Additional Number of Letters to the Republican*, New York, 2 May 1788, DHRC XX (2): 1059.

Federal Farmer then went on and even brought in the idea of destruction, linking it to the power of taxation. He feared that if the Congress was given such a power it could be able to use it not only to raise revenue, but also to destroy freedoms of the people. He gave one example of such an endangered freedom: the freedom of press, on which the Congress could easily impose taxes which would lead to its destruction: 'a power to tax the press at discretion, is a power to destroy or restrain the freedom of it'.<sup>117</sup>

Timoleon was also convinced that the federal power to tax is indeed unlimited, because 'taxing is co-extensive with the *general welfare*, and the *general welfare* is as unlimited as actions and things are that may disturb or benefit that general welfare.'<sup>118</sup> Similarly, A Baptist, another prominent Anti-Federalist, stressed that the federal power to tax in combination with the power of the sword would lead to 'oppressing the people, and greatly endangering public liberty'.<sup>119</sup>

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<sup>117</sup> *Federal Farmer: An Additional Number of Letters to the Republican*, New York, 2 May 1788, DHRC XX (2): 1059.

<sup>118</sup> 'By this power, the right of taxing is co-extensive with the *general welfare*, and the *general welfare* is as unlimited as actions and things are that may disturb or benefit that general welfare. A right being given to *tax* for the general welfare, necessarily includes the right of judging what is for the general welfare, and a right of judging what is for the general welfare, as *necessarily* includes a power of protecting, defending, and promoting it by all such laws and means as are fitted to that end; for, *qui dat finem dat media ad finem necessaria*, who gives the end gives the means necessary to obtain the end. The Constitution must be so construed as not to involve an absurdity, which would clearly follow from allowing the end and denying the means', *Timoleon*, *New York Journal*, 1 November 1787 (*extraordinary*), DHRC XIX (1): 167.

<sup>119</sup> 'Whether the general legislature can exercise the power to lay and collect internal taxes and excises, to organize and govern the militia, and call them out to *execute the laws of the union*, and suppress insurrections, without grievously oppressing the people, and greatly endangering public liberty?', *A Baptist*, *New York Journal*, 30 November 1787, DHRC XIX (1): 336-337.

#### 4.3.3.3 *The ‘supreme law of the land’ and the ‘proper and necessary’ clauses give unlimited power to the federal government*

Hamilton lamented that the Anti-Federalists, in their attacks on the Constitution warned the people that as a result of those two provisions (‘supreme law of the land’ and the ‘proper and necessary’ clauses): ‘their local governments were to be destroyed and their liberties exterminated’ (*Federalist* 33, PAH IV: 465). Next, he noted that, in fact, these clauses do not change anything in the power architecture of the federal government as ‘[c]onstitutional operation of the intended government would be precisely the same, if these clauses were entirely obliterated, as if they were repeated in every article’ (*Federalist* 33, PAH IV: 466).

Subsequently, Hamilton investigated the two clauses in detail. Firstly, he dissected the ‘necessary and proper’ clause. In order to prove his point, he began with the definition of power by asking a rhetorical question: ‘What is a power, but the ability or faculty of doing a thing?’ Later, he extended this observation to the federal tax laws:

*What is a LEGISLATIVE power but a power of making LAWS?*

*What are the means to execute a LEGISLATIVE power but LAWS?*

*What is the power of laying and collecting taxes but a legislative power, or a power of making laws, to lay and collect taxes? What are the proper means of executing such a power but necessary and proper laws?<sup>120</sup>*

If a certain power is given to the government, then by definition this government

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<sup>120</sup> *Federalist* 33, PAH IV: 466.



would be assigned with the authority to pass all the laws that are necessary to execute such a power. In the contrary was the case, that power would be a dead letter. In his own words: 'a power to lay and collect taxes must be a power to pass all laws NECESSARY and PROPER for the execution of that power.'

Secondly, he dealt with the supremacy clause and started with the definition of law, which by its nature includes supremacy:

*A LAW, by the very meaning of the term includes supremacy. It is a rule which those to whom it is prescribed are bound to observe.*<sup>121</sup>

Next, Hamilton drew a comparison between the individuals who 'enter into a state of society', (by which he meant a state) and these states who enter into the greater 'society', or a federation. Similarly to individuals who must obey the laws of a state they decided to enter, the states which do not want to be acting alone, must obey the laws of the larger 'political society' - the federal laws. Therefore, the federal laws are supreme. Nonetheless, these federal laws are to be 'pursuant to the powers entrusted to it by its constitution'<sup>122</sup> and they cover only a limited area of public policy that the states had agreed to grant to the federal government in the Constitution. Importantly, federal laws are also supreme to the individuals of these states.<sup>123</sup> Without such supremacy of the federal law, a federation would be:

*a mere treaty, dependent on the good faith of the parties, and not a government; which is only another word for POLITICAL POWER*

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<sup>121</sup> *Federalist* 33, PAH IV: 468.

<sup>122</sup> *Federalist* 33, PAH IV: 468.

<sup>123</sup> 'political societies enter into a larger political society, the laws which the latter may enact, pursuant to the powers intrusted to it by its constitution, must necessarily be supreme over those societies, and the individuals of whom they are composed', *Federalist* 33, PAH IV: 468.

By drawing a comparison between the Constitution (and its supremacy clause) and a treaty, Hamilton made an important distinction between an international organization and a federation. In the former, the implementation of a treaty is dependent on the good will of the contracting parties; whereas in a federation, there is a government and a constitution, which is a supreme law. He once again asserted that even though this powerful clause sounds overreaching and dangerous to the states' rights, it could only be applied to the powers explicitly vested to the federation by the Constitution. Otherwise, anything else that would go beyond such enlisted federal competences would constitute unlawful seizure of power.<sup>125</sup>

The same principle that applies to the general laws of the union should be applied to the area of taxation: taxes imposed by the federal government 'would be supreme in its nature, and could not legally be opposed or controuled.'<sup>126</sup> However, any attempt at 'abrogating or preventing the collection of a tax laid by the authority of the State, (unless upon imports and exports)' would be 'usurpation of power not granted by the Constitution.' With regards to the objection that both levels of government could tax the same objects, he claimed that legally neither of them could be controlled, but it is hoped that the mutual interest of both would render sensible tax rates, because any other manner will be 'equally disadvantageous to both.'<sup>127</sup> Ham-

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<sup>124</sup> *Federalist* 33, PAH IV: 468.

<sup>125</sup> 'But it will not follow from this doctrine that acts of the large society which are *not pursuant* to its constitutional powers, but which are invasions of the residuary authorities of the smaller societies, will become the supreme law of the land. These will be merely acts of usurpation, and will deserve to be treated as such', *Federalist* 33, PAH IV: 468.

<sup>126</sup> *Federalist* 33, PAH IV: 469.

<sup>127</sup> 'As far as an improper accumulation of taxes on the same object might tend to render the collection difficult or precarious, this would be a mutual inconvenience, not arising from a superiority or defect of power on either side, but from an injudicious exercise of power by one or the other, in a manner equally disadvantageous to both. It is to be hoped and presumed, however, that mutual interest would dictate a concert in this respect which would avoid any material inconvenience', *Federalist* 33, PAH IV: 465.

ilton concluded his elaboration by repeating a declaration that:

*States would, under the proposed Constitution, retain an independent and uncontrollable authority to raise revenue to any extent of which they may stand in need by every kind of taxation, except duties on imports and exports.*<sup>128</sup>

The observation that states' right of raising any form of revenues except duties on exports addressed a concern of Brutus who feared the supreme law clause grants the Congress a power to repeal the revenue laws of the states.<sup>129</sup> This is important, because having the right to impose taxes would mean that the states would retain their financial autonomy. How both the states and federal taxes would be collected though was a different matter, a topic I turn to in the following section.

#### **4.3.3.4 *The expansion of the federal tax administration***

The future Secretary of the Treasury presented arguments regarding the expansion of the federal tax administration and subsequently discussed each of them separately. First, he examined the danger of a double set of tax officers in the states. He argued that, in some cases (e.g. duties on imports) it would be impossible because some kind of tax could be levied only by the federation. In other cases, the federal

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<sup>128</sup> *Federalist* 33, PAH IV: 469.

<sup>129</sup> 'Suppose the legislature of a state should pass a law to raise money to support their government and pay the state debt, may the Congress repeal this law, because it may prevent the collection of a tax which they may think proper and necessary to lay, to provide for the general welfare of the United States? For all laws made, in pursuance of this constitution, are the supreme law of the land, and the judges in every state shall be bound thereby, any thing in the constitution or laws of the different states to the contrary notwithstanding. — By such a law, the government of a particular state might be overturned at one stroke, and thereby be deprived of every means of its support', *Brutus I*, *New York Journal*, 18 October 1787, DHRC XIX (1): 109.

government 'will either wholly abstain from the objects preoccupied for local purposes' and leave the state to raise revenue from this objects, and it would use state revenue officers for collecting federal portion of a given tax. Avoiding the use of federal officers in the states would have two important advantages. First, it would reduce the costs of tax collection. It would also not annoy the states and their people - 'and will best avoid any occasion of disgust to the State governments and to the people' (*Federalist* 36, PAH IV: 488). Hamilton proceeded to reject the idea that if state officers were to be hired by the federal government, that would create a situation in which those officers will be more loyal to the federation rather than the states. Hamilton turned this argument on its head, a method frequently employed in the art of rhetoric, and consequently argued that it would be the exact opposite: these officers would provide the instrument for the state to influence the federal government.<sup>130</sup>

Federal Farmer stressed the importance of the mode of execution of power, by which he probably meant the issue of federal tax collection:

*The quantity of power the union must possess is one thing, the mode of exercising the powers given, is quite a different consideration.*<sup>131</sup>

This observation relates to the idea of the federal government having the ability to act directly on individuals without the need to pass through the states' governments. As Federal Farmer noticed: 'To illustrate my idea—the union makes a requisition, and assigns to each state its quota of men or monies wanted; each state, by its own laws and officers, in its own way, furnishes its quota: here the state govern-

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<sup>130</sup> '(..)to employ the State officers as much as possible, and to attach them to the Union by an accumulation of their emoluments. This would serve to turn the tide of State influence into the channels of the national government, instead of making federal influence flow in an opposite and adverse current', *Federalist* 36, PAH IV: 488.

<sup>131</sup> *Federal Farmer: An Additional Number of Letters to the Republican*, New York, 2 May 1788, DHRC XX (2): 1061.

ments stand between the union and individuals; the laws of the union operate only on states'.<sup>132</sup> He later confronted this mode with the notion of federal officers collecting taxes directly. In his view, such a mode:

*entirely excludes the agency of the respective states, and throws the whole business of levying and collecting taxes, &c. [etc] into the hands of many thousand officers solely created by, and dependent upon the union, and makes the existence of the state government of no consequence in the case.*<sup>133</sup>

According to Federal Farmer federal taxes should be collected on the state level, and the system of requisitions should be implemented again.<sup>134</sup> He envisioned that impost duties would be insufficient for the federal government (in fact, until the Civil War, impost duties amounted to over 90 percent of the federal revenues [Woźniakowski and Steinmo 2018]) and warned against the large number of federal tax collectors who would be employed for the purpose of internal taxation due to the vast territory of the US:

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<sup>132</sup> *Federal Farmer: An Additional Number of Letters to the Republican*, New York, 2 May 1788, DHRC XX (2): 1061.

<sup>133</sup> *Federal Farmer: An Additional Number of Letters to the Republican*, New York, 2 May 1788, DHRC XX (2): 1061.

<sup>134</sup> 'By this federal plan, with this exception mentioned, we secure the means of collecting the taxes by the usual process of law, and avoid the evil of attempting to compel or coerce a state; and we avoid also a circumstance, which never yet could be, and I am fully confident never can be, admitted in a free federal republic; I mean a permanent and continued system of tax laws of the union, executed in the bowels of the states by many thousand officers, dependent as to the assessing and collecting federal taxes, solely upon the union. On every principle then, we ought to provide, that the union render an exact account of all monies raised by imposts and other taxes; and that whenever monies shall be wanted for the purposes of the union, beyond the proceeds of the impost duties, requisitions shall be made on the states for the monies so wanted; and that the power of laying and collecting shall never be exercised, except in the cases where a state shall neglect, a given time, to pay its quota. This mode seems to be strongly pointed out by the reason of the case, and spirit of the government; and I believe, there is no instance to be found in a federal republic, where the congressional powers ever extended generally to collecting monies by direct taxes or excises. Creating all these restrictions, still the powers of the union in matters of taxation, will be too unlimited; further checks, in my mind, are indispensably necessary', *Federal Farmer: An Additional Number of Letters to the Republican*, New York, 2 May 1788, DHRC XX (2): 1068.

*taxes more productive than the impost duties will, probably, be wanted to support the government, and to discharge foreign demands, without leaving any thing for the domestic creditors. The internal sources of taxation then must be called into operation, and internal tax laws and federal assessors and collectors spread over this immense country.*<sup>135</sup>

He further asserted that: 'Internal taxation in this country is more important, as the country is so very extensive. As many assessors and collectors of federal taxes will be above three hundred miles from the seat of the federal government as will be less'.<sup>136</sup>

#### ***4.3.3.5 It would lead to the increase of the overall burden of taxation***

According to the reasoning of Federal Farmer, concurrent power of taxation, especially in excises and direct taxation, would lead to the overall increase in the tax burden. This would be, as he later argued, due to the fact that these internal taxes inherit no limit against their excessive use.<sup>137</sup>

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<sup>135</sup> *Federal Farmer, Letters to the Republican*, 8 November 1787, DHRC XIX (1): 225.

<sup>136</sup> *Federal Farmer, Letters to the Republican*, 8 November 1787, DHRC XIX (1): 225.

<sup>137</sup> 'To this we may observe, that trade generally finds its own level, and will naturally and necessarily heave off any undue burdens laid upon it: further, if congress alone possess the impost, and also unlimited power to raise monies by excises and direct taxes, there must be much more danger that two taxing powers, the union and states, will carry excises and direct taxes to an unreasonable extent, especially as these have not the natural boundaries taxes on trade have. (...) further, if congress alone possess the impost, and also unlimited power to raise monies by excises and direct taxes, there must be much more danger that two taxing powers, the union and states, will carry excises and direct taxes to an unreasonable extent, especially as these have not the natural boundaries taxes on trade have. However, it is not my object to propose to exclude congress from raising monies by in-

A Son of Liberty, contrary to Federal Farmer, warned against the poll tax, which would be an even larger burden for the poor than for the rich, since the former tend to have more children:

*An arbitrary capitation or poll tax, by which the poor, in general, will pay more than the rich, as they have, commonly, more children, than their wealthy dissipated neighbours.*<sup>138</sup>

A Son of Liberty also claimed that the Constitution would lead to the collection of 'exorbitant taxes' without the consent of the people which would 'break (...) their spirits' and 'prevent revolt.'<sup>139</sup>

**4.3.3.6** *It is against the principle 'no taxation without representation': 'people will be taxed without their consent, as large part of the population won't be represented in the federal Congress'*

Federal Farmer raised an objection against unlimited federal tax power based on the idea that it is against the principle 'no taxation without representation', and that the House of Representatives will not represent people as it should: 'Indeed the

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ternal taxes, as by duties, excises, and direct taxes; but my opinion is, that congress, especially in its proposed organization, ought not to raise monies by internal taxes, except in strict conformity to the federal plan; that is, by the agency of the state governments in all cases, except where a state shall neglect, for an unreasonable time, to pay its quota of a requisition; and never where so many of the state legislatures as represent a majority of the people, shall formally determine an excise law or requisition is improper, in their next session after the same be laid before them', *Federal Farmer: An Additional Number of Letters to the Republican*, New York, 2 May 1788, DHRC XX (2): 1067-1068.

<sup>138</sup> *A Son of Liberty*, *New York Journal*, 8 November 1787, DHRC XIX (1): 135.

<sup>139</sup> 'The citizens constantly subjected to the insults of military collectors, who will, by the magnetism of that most powerful of all attractives, the bayonet extract from their pockets (without their consent) the exorbitant taxes imposed on them by their haughty lords and masters, for the purpose of keeping them under, and breaking their spirits, to prevent revolt', *A Son of Liberty*, *New York Journal*, 8 November 1787, DHRC XIX (1): 135-136.

representation proposed will hardly justify giving to congress unlimited powers to raise taxes by imposts, in addition to the other powers the union must necessarily have.’<sup>140</sup> Federal Farmer trusted local assemblies more, because they reflect the will of the people much better than the federal government would ever be able to.<sup>141</sup> He attacked federal power to tax on the grounds that the new Congress will be too small to sufficiently represent the people. And because the people have the right to be taxed with consent of their representatives, the new government will not fulfill the criterion of ‘no taxation without representation’. For this reason as long as the Congress is not reformed to be more representative, it should not be given the power to tax. By asking few rhetorical questions Federal Farmer further supported his argument:

*It is not only unsafe but absurd to lodge power in a government before it is fitted to receive it? It is confessed that this power and representation ought to go together. Why give the power first?*<sup>142</sup>

He then concluded that if the requirement of representation will not be fulfilled, the power to tax should stay with the states: ‘If a proper representation be impracticable, then we shall see this power resting in the states, where it at present ought to be, and not inconsiderately given up.’<sup>143</sup> He was particularly concerned that the middle

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<sup>140</sup> *Federal Farmer: An Additional Number of Letters to the Republican*, New York, 2 May 1788, DHRC XX (2): 1067.

<sup>141</sup> ‘Nor do I conceive, that as full a representation as is practicable in the federal government, will afford sufficient security: the strength of the government, and the confidence of the people, must be collected principally in the local assemblies; every part or branch of the federal head must be feeble, and unsafely trusted with large powers. A government possessed of more power than its constituent parts will justify, will not only probably abuse it, but be unequal to bear its own burden; it may as soon be destroyed by the pressure of power, as languish and perish for want of it.’, *Federal Farmer: An Additional Number of Letters to the Republican*, New York, 2 May 1788, DHRC XX (2): 1068.

<sup>142</sup> *Federal Farmer, Letters to the Republican*, 8 November 1787, DHRC XIX (1): 225.

<sup>143</sup> *Federal Farmer, Letters to the Republican*, 8 November 1787, DHRC XIX (1): 225. See also: ‘All these circumstances considered, is it wise, prudent, or safe, to vest the powers of laying and collecting internal taxes in the general government, while imperfectly organized and inadequate; and to trust to amending it hereafter, and making it adequate to this purpose? It is not only unsafe but absurd to



and lower classes of citizens will not be properly represented and even though for many purposes federal government could be representative enough, it is not the case for the purpose of taxation: 'to suppose that this branch is sufficiently numerous to guard the rights of the people in the administration of the government, in which the purse and sword is placed, seems to argue that we have forgot what the true meaning of representation is'.<sup>144</sup>

In his concluding remarks, Hamilton made an observation that taxation requires the most extensive set of skills and talents, which will guarantee that taxes will not be excessive: 'There is no part of the administration of government that requires extensive information and a thorough knowledge of the principles of political economy, so much as the business of taxation. The man who understands those principles best will be least likely to resort to oppressive expedients, or sacrifice any particular class of citizens to the procurement of revenue.' He finished by asserting his fellow

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lodge power in a government before it is fitted to receive it? It is confessed that this power and representation ought to go together. Why give the power first? Why give the power to the few, who, when possessed of it, may have address enough to prevent the increase of representation? Why not keep the power, and, when necessary, amend the constitution, and add to its other parts this power, and a proper increase of representation at the same time? Then men who may want the power will be under strong inducements to let in the people, by their representatives, into the government, to hold their due proportion of this power. If a proper representation be impracticable, then we shall see this power resting in the states, where it at present ought to be, and not inconsiderately given up.' *Federal Farmer, Letters to the Republican*, 8 November 1787, DHRC XIX (1): 225-226; 'When I recollect how lately congress, convention, legislatures, and people, contended in the cause of liberty, and carefully weighed the importance of taxation, I can scarcely believe we are serious in proposing to vest the powers of laying and collecting internal taxes in a government so imperfectly organized for such purposes. Should the United States be taxed by a house of representatives of two hundred members, which would be about fifteen members for Connecticut, twenty-five for Massachusetts, &c. still the middle and lower classes of people could have no great share, in fact, in taxation. I am aware it is said, that the representation proposed by the new constitution is sufficiently numerous; it may be for many purposes; but to suppose that this branch is sufficiently numerous to guard the rights of the people in the administration of the government, in which the purse and sword is placed, seems to argue that we have forgot what the true meaning of representation is. I am sensible also, that it is said that congress will not attempt to lay and collect internal taxes; that it is necessary for them to have the power, though it cannot probably be exercised.—I admit that it is not probable that any prudent congress will attempt to lay and collect internal taxes, especially direct taxes: but this only proves, that the power would be improperly lodged in congress, and that it might be abused by imprudent and designing men', *Federal Farmer, Letters to the Republican*, 8 November 1787, DHRC XIX (1): 226.

<sup>144</sup> *Federal Farmer, Letters to the Republican*, 8 November 1787, DHRC XIX (1): 225.

citizens that interest of government and citizens goes hand in hand, since:

*the most productive system of finance will always be the least burdensome.*<sup>145</sup>

Hamilton concluded that tax policy makers need to know the country and their citizens, they should have 'general genius, habits, and modes of thinking of the people at large, and with the resources of the country' (*Federalist* 35, PAH IV: 482). As a result, he seemed to refuse the idea (or rather - an accusation) of Federal Farmer that representatives in the federal Congress will be too detached from the people and will not be sufficiently acquainted with the habits and modes of the people from particular states.

To recapitulate, in this section I explored the arguments regarding the negative consequences of the federal power to tax. In total, I distinguished six such arguments, which were the following:

1. The states would be left with no money, since federal government would collect all the taxes;
2. The federal government would use the money to oppress the people and repress their liberties;
3. The 'supreme law of the land' and the 'proper and necessary' clauses give unlimited power to the federal government;
4. The expansion of the federal tax administration;
5. The increase of the overall burden of taxation;
6. It is against the principle of 'no taxation without representation': 'the people will be taxed without their consent, as a large part of the population will not be represented in the federal Congress.'

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<sup>145</sup> *Federalist* 35, PAH IV: 482.

These arguments were used by the Anti-Federalists who were against the establishment of the federal government with a power to tax. Due to the nature of these arguments and their authors - the Anti-Federalist who opposed the Constitution as such - I did not expect to find evidence to confirm my hypothesis. Quite the contrary, these authors recognized an emerging federal government as a threat, to both the states and the people. In reference to the former, it was argued that fiscalization in connection with other clauses of the Constitution ('supreme law of the land' and the 'proper and necessary' clause) will lead to unlimited federal fiscal power. As a result, the states will be left with no money. In regards to the latter, it was argued that the federal Congress will not represent the people to the same extent as the states' legislature do, and consequently this would lead to the oppression of their liberties, not least in the form of oppressive tax burden imposed by the powerful federal tax administration. Clearly, Anti-Federalists were also anti fiscalization, but the arguments they presented during the ratification process apparently were not convincing enough and they lost the political struggle as a consequence.

## 4.4 Summary

The original contribution to knowledge of this chapter is the demonstration that a threat emerging from the sovereign debt crisis during the post-war economic recession in the mid-1780s was the single-most important cause of the federal power to tax clause in the Constitution of 1787. The social unrest in the form of the tax protests of 1786-1787 constituted an internal threat for the new union. These tax protests could easily spill over to the other states and it was only because Shays, the leader of the most serious rebellion, was not 'Cromwell or Caesar', to use Hamilton's comparison, that the rebellion was suppressed. This fear over protests united the elites from the states, who formed a coalition in favor of a strong federal government. The federal tax power was viewed as the most important means of preventing such crises from threatening the existence of the union in the future, as I showed in this chapter.

Consequently, both Section 4.2, which tracked the process leading to fiscalization, and Section 4.3, which investigated the arguments concerning fiscalization (as summarized in Table 3 below), confirmed my hypothesis, that it was a perceived threat that led to fiscalization of the federal government. Especially, the part on the negative consequences of the requisition system provided a number of arguments relating to a threat. For instance, it was argued that the system based of states' contributions to the central budget will lead to the dissolution of the Union; that the states will constantly negotiate the level of their contribution; and that the coercion of the states to pay their fair share (in the case of a non-compliance) may even lead to a civil war. However, the threat factor was not limited to this group of arguments.

Notably, in the group of positive the consequences of fiscalization, a prominent argument stated that such a fiscal power on the side of the federal government would help the Union to tackle the future threats, or ‘exigencies’, as the Federalists called it. In fact, it was a major argument in favor of fiscalization.

**Table 3. The main arguments concerning federal power to tax in the US**

Type of arguments	Arguments
1. The Negative Consequences of the Requisition System	1.1. Plunder of the people and ‘atrophy’ of the Union, followed by its dissolution;
	1.2. States constantly negotiate the level of their contributions;
	1.3. The coercion of states to comply with federal fiscal directives (which is madness and leads to civil war).
2. The Positive Consequences of the Federal Power to Tax	2.1. Federal credit and the ability to borrow at low rates;
	2.2. A possibility to tackle future unpredictable exigencies: A Constitution written for centuries, not decades;
	2.3. States will contribute equally based on their wealth, and not on a direct exposure to a threat;
	2.4. Federal responsibilities will be matched with federal resources;
	2.5. The unlimited federal power to tax will paradoxically lead to lower tax rates;

	2.6. Unlimited power within a limited sphere;
	2.7. The federal government will be able to act directly on citizens;
	2.8. The fiscal needs of the states will diminish, as some of their responsibilities will be shifted to the federal level;
	2.9. Federal taxes will have a natural limit against excess;
	2.10 Fiscalization will lead to a more democratic government.
3. The Negative Consequences of the Federal Power to Tax	3.1. The states would be left with no money, since federal government would collect all the taxes
	3.2. The federal government would use; the money to oppress the people and repress their liberties;
	3.3. The 'supreme law of the land' and the 'proper and necessary' clauses give unlimited power to the federal government;
	3.4. The expansion of the federal tax administration;
	3.5. The increase of the overall burden of taxation;
	3.6. It is against the principle of 'no taxation without representation': 'the people will be taxed without their consent, as a large part of the population won't be represented in the federal Congress.'

Source: Own Illustration.

For instance, in his speech on June 21, 1788, Hamilton made the case that the federal power to tax cannot be limited to the custom duties ('impost'), but has to be extended to also include internal taxation (by which he most likely meant direct taxation), even if in normal times such an extended power would not be used by Congress. Rather, it would be used only in the case of emergency, in 'times of great danger and distress', and even then, it would be adjusted to 'the laws and customs of each state', because the representatives would learn how to tax by studying laws of particular states, which 'will teach them the most certain, safe and expeditious mode of laying and collecting taxes in each state.'<sup>146</sup>

Moreover, the evidence demonstrates that the Federalists were successful in tackling the Anti-Federalists' arguments on the negative consequences of fiscalization. A danger that the federal power to tax would lead to an increase in the tax burden for the average citizens, seemed to be the most important source of anxiety for society. For this reason, the Federalists confronted this argument by assuming that the contrary will happen - fiscalization would paradoxically lead to the lower tax burden for the average citizens.

To this end, Hamilton argued that the revenue for the federal expenditures has to be delivered in a one way or another - either by the federal government raising its own revenue or by relying on the contributions of the states. Regardless of the means of obtaining the revenue, the amount of revenues needed for the federal government would not change. Furthermore, Hamilton claimed that giving the federal government the power to tax would have one important advantage for the ordinary people: the Union would be able to impose taxes on imports, which the states for various reasons (i.e. due to the tax competition) cannot do so effectively on their own. In turn, this would lower the level of the tax burden which would be imposed on the 'the poorer and most numerous classes of the society', as the states

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<sup>146</sup> *New York Ratifying Convention Third Speech of June 21* (FRANCIS CHILDS'S VERSION) [1788], PAH V: 56-57.

would no longer need to impose heavy direct taxes. He concluded by linking the prosperity of the federal government with the fortune of the ordinary people:

*Happy it is when the interest which the government has in the preservation of its own power, coincides with a proper distribution of the public burdens, and tends to guard the least wealthy part of the community from oppression!*<sup>147</sup>

In this chapter I demonstrated how the process of fiscalization emerged in the US, and that the quasi-regulation was a dominant feature of its fiscal integration up to the moment when a threat changed the political dynamics and triggered a paradigm shift (i.e. a shift in the instrument of integration - from regulation to fiscalization) in the form of the federal power to tax. The opposite can be observed in another federal-like polity - the EU, in which a threat did cause a change, but it was not a change of paradigm (although, we can observe some new mechanisms which I labeled quasi-fiscalization), but the enhancement of the existing instrument of fiscal integration - the regulation of fiscal policies of the member states, a topic I explore to in the following chapter.

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<sup>147</sup> *Federalist* 36, PAH IV: 489.





# 5 Fiscal regulation of the EU

*[Euro Area] reforms made thus far, featuring an evident domination of fiscal solutions may expose Europe to long-standing political conflicts and social unrest.*

Nowak and Ryc<sup>148</sup>

## 5.1 Introduction

In the previous Chapter 4 I showed that the US in the 1780s faced the sovereign debt crisis of its member states. It was a very similar problem to the Euro crisis of the 2010s. However, the solutions chosen to solve this problem were fundamentally different: whereas in the US this debt crisis triggered the process of *fiscalization* of the federal government, in the EU we have witnessed only attempts to reach such solutions by the EU institutions (see, e.g., European Commission 2012: 31-34; Monti et al. 2016) and the member states (Macron and Gabriel 2015). In the place of a EU tax power, the European sovereign debt crisis instead accelerated the process of *regulation of the fiscal policies of the member states* (or - *fiscal regulation*). The differences

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<sup>148</sup> 'Capability and Convergence as Imperative for the Euro Area Persistence', in Nowak, Alojzy Z. (ed.), *Global Financial Turbulence in the Euro Area. Polish Perspective*, Frankfurt am Main: Peter Land 2015: 158.

between these instruments of fiscal integration - fiscalization and fiscal regulation - were discussed in detail in Chapter 2.3 (see also Woźniakowski 2017).

For instance, under the European Semester the EU can even impose sanctions if the member states fail to take 'the corrective action' on the excessive macroeconomic imbalances or in the case of a failure to correct an excessive deficit. As mentioned before, it was decided not to go forward with the fiscalization process. The EU budget is small (about 1 % of the EU's Gross Domestic Product) and it still relies almost exclusively on contributions from the member states, which jealously protect their fiscal sovereignty and for this reason the EU has a very little fiscal capacity. Paradoxically, by not agreeing to give the EU a larger fiscal capacity, member states gave up more of this very fiscal sovereignty to the central institutions - in the form of fiscal regulation - than states in classical federations, such as the US.

I hypothesize that this was because the threat emerging from the Euro crisis was not perceived as large enough to trigger a fiscal bargain, as outlined in Chapter 2.4, which would lead to fiscalization of the EU. In order to test my hypothesis, in Chapter 5.3, I analyze the preferences of the member states regarding the EU's fiscalization. In order to do so, I examined the contributions that all the member states, but Greece, provided in 2015, as part of a debate on a strategic EU document outlining institutional options for the future of the EU, the so called Five Presidents' Report. This allowed me to group the member states in regard to their preferences on fiscalization - to what extent the member states were mentioning a threat as a reason for fiscalization? - and to list the arguments that have been used. By listing those arguments, I found that a threat was not the most prominent factor. Nevertheless, it did exist, and it was enough to trigger a process of quasi-fiscalization, as I demonstrate in Section 5.2.3. Still, regulation remains the main instrument of fiscal integration, as I demonstrate in Section 5.2.2.

Empirically, this chapter is limited to the mechanisms that have been implemented

and therefore I do not discuss, with the important exception of the idea of fiscalization, the proposals that were circulated during the Euro crisis, but have never been implemented, such as the Eurobonds or the Financial Transaction Tax. Moreover, I do not focus on the variety of EU responses to the Euro crisis per se, but on the new institutions that have been created, instead. Therefore, I do not discuss a number of financial assistance packages, so called bail-outs, neither do I focus on the actions of the European Central Bank (ECB), which - while extremely important for 'saving the euro' - do not directly relate to the main focus of this dissertation - the fiscalization process. Moreover, it would not be feasible to examine all these proposals and policies in one dissertation.

Consequently, this chapter is divided into three parts. In the first one (Section 5.1) I present the background of the Euro crisis and its impact on the general institutional set-up of European economic governance. The second part, Section 5.2 is further divided into two sub-sections: on fiscal regulation (Section 5.2.2) and quasi-fiscalization (Section 5.2.3), in which I provide a detailed analysis of the new institutions in the light of my theoretical framework, as outlined in Chapter 2. In the third part of this chapter (Section 5.3), I delve deeper into the preferences of the member states regarding the prospect of fiscalization. I will show that a threat factor, while present, was not very prominent in the arguments, which were provided by the member states. This, I argue, explains the lack of fiscalization in the EU.

Nevertheless, the reasons that were given to justify fiscalization did include an economic threat factor, as I will demonstrate further down in Section 5.3.2, such as asymmetric shocks. While the threat was not strong enough to trigger a full-fledged fiscalization process, it nevertheless triggered a process I call quasi-fiscalization (for the overview of the different instruments of fiscal integration see Table 4 below), in the form of lending institutions, such as the European Stability Mechanism (ESM). Table 4 shows how the EU changed the instruments of its economic governance as a

result of the threat emerging from the Euro crisis that out broke in 2010. While in the ‘pre-threat’ governance stage, it relied mainly on a weak regulation of the fiscal policies of the member states, in the ‘post-threat’ economic governance period, this regulation instrument was significantly strengthened and the new instrument of fiscal integration started to be implemented - quasi-fiscalization.

**Table 4. Fiscalization and the regulation of the fiscal policies of the member states in the EU**

<b>Period</b>	<b>Instrument of integration</b>
Pre-threat (until 2010)	Weak regulation
Post-threat (after 2010)	Strong regulation + Quasi fiscalization

Source: Own Illustration.

In the literature, the two possible instruments of fiscal integration are called regulation and fiscal capacity (Hallerberg 2013). With the reference of the latter, as explained in Chapter 2.3, this dissertation uses a concept of fiscalization, rather than ‘fiscal capacity’. In the following section I will explore in detail these two different instruments of integration used by the EU in its ‘post-threat’ economic governance period, as shown in Table 4 above.

## 5.2 How did the EU's fiscal regulation emerge?

### *5.2.1 Background*

The global economic crisis, which began after the Lehmann Brothers Holdings Inc., the fourth largest investment bank in the US, declared bankruptcy in late 2008, later on has spilled over to Europe and was dubbed the 'Euro crisis'. This crisis manifested itself in the sovereign debt crisis of the Euro Area member states that started in 2010. We can divide the countries that found themselves in the fiscal trouble in the two categories. The first one concerns those states, which already had a significant debt and the crisis only accelerated this trend. Importantly, such financing of the states' policies by debt was possible when those countries joined the Euro Area and a cheap credit from the banks from Northern Europe became available. Greece is the most notable example of this group. The second group consists of countries that maintained balanced budgets, but this changed when the crisis broke and those countries decided to bailout their banks. Those banks were large institutions that operated at the international level and if they would fail, the consequences would be severe not only for the countries where the banks happened to have headquarters, but for the rest of the EU.

As there was no European mechanism that could provide needed bailout at the time, the national budgets had to bear all the costs of saving the banks. Ireland is the most notable example of this group. This situation showed that a given country may have a balanced budget, but due to some macroeconomic imbalances it may suddenly accumulate a large debt. As a consequence, it was decided that the rules governing the level of indebtedness had to be strengthened (as was done through

the enforced Excessive Deficit Procedure [EDP]), but also - in order to prevent the situation that happened in the second group of countries described above - a new mechanism of surveillance of macroeconomic imbalances was created (as was done through the (Excessive) Macroeconomic Imbalance Procedure [MIP]), as I show further down in Section 5.2.2 and as summarized in Table 5 below.

Importantly, these institutional changes are not merely about enhancing existing rules to make them more enforceable, but represents much more fundamental shift. Namely, it was a shift from 'rules' to decisions', which creates a number of issues, including the accountability challenge (Dawson 2015). As I will show in this chapter, the decision not to go forward with the fiscalization process, which would lead to a large EU budget that could be used to deal with the economic shocks such as those that the Euro crisis had brought, and to strongly strengthen the regulation framework of the EU instead, has a serious consequence. Namely, it gave a number of EU institutions, especially the Commission, a large 'discretionary space' to intervene in the domestic policy-making of the member states. Importantly, those include not only the level of indebtedness, but also - within the Macroeconomic Imbalance Procedure - recommendations on virtually all other policies, such as taxation or public health. Significantly, the EU can impose financial sanctions for the countries that fail to follow these recommendations. The range of those fines is between 0.1% and 0.5% of GDP of a given country, depending on the procedure within which recommendations are issued. Moreover, the Fiscal Compact, an international treaty signed by all EU member states but the UK and the Czech Republic, requires the signatories to implement the golden rule of balanced budget in their domestic law and also includes a possibility of sanctions. Those sanctions are summarized in Table 5 below.

**Table 5. Financial sanctions under the new economic governance of the EU**

<b>Procedure</b>	<b>The level of sanction as a % of GDP of a given member state</b>
The Fiscal Compact	0.1
The Excessive (Macroeconomic) Imbalance Procedure	0.1
The Excessive Deficit Procedure	0.2 – 0.5

Note: The sanctions usually take three forms: first, a non-interest-bearing deposit, then an interest-bearing deposit which finally may be turned into a fine.

Source: own Illustration.

For instance, within the EDP a country that consistently fails to obey the rule of keeping its deficit below 3% of its GDP may be sanctioned a fine of 0.2 % which may increase up to 0.5% (at first it is a non-interest-bearing deposit, which may be turned into a fine). This number may appear small at first, but if one calculates how much it would actually be in nominal values, the sum is far from being insignificant.

For instance, in the case of Spain whose GDP is around 1 trillion euros, the fine of 0.2 % would be 2 billion euros. In 2016 two countries were at risk of sanctioning - Portugal and Spain (Financial Times 2016)<sup>149</sup>. However, the Commission decided not to sanction them, regardless of their consistent lack of progress in reducing the deficit below the required threshold. It was widely seen as a political decision that

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<sup>149</sup> In 2003 France and Germany have not been sanctioned for breaking the fiscal rules, which demonstrated that the rules are subject to political decisions, a topic I discuss further down in this chapter.



was taken in order to avoid a further anti-EU sentiment in those countries. Remarkably, the two countries from the Iberian Peninsula were the most prominent proponents of fiscalization, as I show in Chapter 5.3.

In the wake of the Euro crisis a number of actions have been taken by the member states of the EU with the aim of ‘preserving the euro’. These actions have taken many forms: many of them were part of the EU legal framework (for instance, two sets of legislation, which aim at strengthening the SGP: the so-called Six-Pack and the Two-Pack), as explained in Section 5.2.2, but some were created outside the EU legal framework in the form of intergovernmental treaties - the Fiscal Compact, investigated in Section 5.2.2, and the European Stability Mechanism, explored in Section 5.2.3. The main emphasis was put on the surveillance of the member states’ fiscal policies (the European Semester, elaborated on in Section 5.2.2). Moreover, the competences of several existing institutions have been reshaped (the Commission) and the new, temporal (the European Financial Stabilization Facility, explained in Section 5.2.3), as well as permanent (the European Stability Mechanism), institutions have been created.

These new institutions can be categorized as falling within the definition of one of the two instruments of fiscal integration:

1. **Regulation** of member states’ fiscal and macroeconomic policies;
2. **Quasi- Fiscalization.**

As Table 6 below shows, the former instrument of integration took a form of the European Semester and the Fiscal Compact, while the latter - of lending institutions, both supranational - EFSM and intergovernmental - EFSF/ESM.

The following sections aim to help filling the gap in the literature by investigating these two instruments of fiscal integration: regulation, which is explored in the following Section 5.2.2, and (quasi) fiscalization, which I analyze in Section 5.2.3.

**Table 6. Examples of regulation and quasi-fiscalization in the EU**

Instrument of integration	Empirical examples
<b>Regulation</b> of member states' fiscal and macroeconomic policies,	The European Semester (the Stability and Growth Pack, the Six Pack, the Two Pack) and the Fiscal Compact
<b>(Quasi) Fiscalization,</b>	The lending institutions (the EFSM and the EFSF/ESM)

Source: Own Illustration.

Chapter 5.2 comprehensively demonstrates how exactly the EU encroached on the fiscal policies of its member states, mainly by using the threat of financial sanction in the case of non-compliance with its recommendations, in addition to the analysis of the quasi fiscalization process.

### 5.2.2 Fiscal regulation

The regulation of the fiscal policies of the EU's member states was strengthened by the three packages of legal acts: the Six-Pack (2011), Two-Pack (2013) and the Fiscal Compact (2012). Those legal acts, despite their different legal grounds<sup>150</sup>, have the same aim: reinforcement of the Stability and Growth Pact (SGP), which governs the EU's fiscal regulation. By enhancing the fiscal regulatory power of the supranational institutions, mainly the Commission, those acts strengthened the credibility of the SGP.

The Resolution of the European Council on the Stability and Growth Pact (17 June 1997) laid out a framework for fiscal regulation. As a result, the regulations creating two arms of the SGP were implemented. First, the preventive arm was established in the Council Regulation (EC) 1466/97 of 7 July 1997 on the strengthening of the surveillance of budgetary positions and the surveillance and coordination of economic policies [1997] OJ L209/1. Second, the corrective arm was created in the Council Regulation (EC) 1467/97 of 7 July 1997 on speeding up and clarifying the implementation of the excessive deficit procedure [1997] OJ L209/6.

The Six-Pack, the first package of the new laws, which further reinforced the provisions of the SGP, was agreed upon in September 2011 and consists of five regulations and one directive. The four documents (three regulations and one directive) that concern regulation of fiscal policy of the member states are:

1. Regulation 1173/2011: *On the effective enforcement of budgetary surveillance in the euro area.*

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<sup>150</sup> The Six-Pack and the Two-Pack are part of the EU law, while the Fiscal Compact is not.

2. Regulation 1175/2011 amending Regulation 1466/97: *On the strengthening of the surveillance of budgetary positions and the surveillance and coordination of economic policies.*
3. Regulation 1177/2011 amending Regulation 1467/97: *On speeding up and clarifying the implementation of the excessive deficit procedure.*
4. Directive 2011/85/EU: *On requirements for budgetary frameworks of the Member States.*

The two regulations concerning macroeconomic imbalances of the member states are:

5. Regulation 1174/2011: *On enforcement action to correct excessive macroeconomic imbalances in the euro area.*
6. Regulation 1176/2011: *On the prevention and correction of macroeconomic imbalances.*

The Two Pack was a second legal package aiming at strengthening the new EU economic governance and was introduced in 2013 in order to strengthen the surveillance of macroeconomic imbalances. It concerns only the Euro Area countries. Specifically, it aimed at reinforcing the monitoring role of the Commission over the economic policies of the member states. The Two Pack regulations aim first of all at completing the European Semester and secondly, at strengthening the surveillance mechanism over countries experiencing financial difficulty, i.e. those receiving financial assistance. The two regulations are the following:

1. Regulation 473/2013: *On common provisions for monitoring and assessing draft budgetary plans and ensuring the correction of excessive deficit of the Member States in the euro area.*
2. Regulation 472/2013: *On the strengthening of economic and budgetary surveillance of Member States in the euro area experiencing or threatened with serious difficulties with respect to their financial stability*

The Six Pack was initiated by the Commission in September 2010, but fourteen months passed until it was adopted in November 2011. The length of this process can be explained by a power struggle between EU institutions in agenda setting (the Commission and the Council) and law making (those two institutions and the European Parliament) (Laffan and Schlosser 2015). The Six Pack came into force on 13 December 2013 as a secondary EU law, and as such this legal package applies to all EU member states. However, within the Six Pack we can observe differentiation for Euro Area members and other member states. The former group is subject to stricter oversight and enforcement, which takes mainly two forms. First, all Euro Area governments have to submit not only three-year economic plans in April to the Commission, but also the drafts of their budgets for the following year. These budget drafts have to be submitted for the Commission's approval in autumn, before they are sent to the respective national parliaments.

Second, in the case of non-compliance the Euro Area member states may face financial sanctions, in the form of interest-bearing and non-interest-bearing deposits, that may be turned into fines, ranging from 0.1 to 0.5 % of their GDP. While those sanctions are far from being automatic - the Commission has to take a number of steps before such a drastic measure could be implemented - its enforcement mechanism has been strengthened in order to enhance its credibility and avoid a situation as the one which occurred from 2003 onwards, when Germany and France have not been sanctioned for breaking the fiscal rules because of the decision of the Council.

Namely, from now on qualified majority voting will be needed not to implement sanctions, but to overcome them (so called reverse qualified majority voting or RQMV), making it more difficult for a concerned state to gather a coalition of 55% of states constituting 65% of EU's population. As a result, a fine can be imposed by the decision of a minority of the Council.

The Six Pack also introduced surveillance mechanisms over national expenditures into the already existing Excessive Deficit Procedure. Now, the Commission has the power to give an early warning to the country, which it deems of spending too much. Furthermore, it becomes easier to trigger the deficit procedure as it can now be based also on the level of debt and not just deficit. Specifically, it is sufficient for the country to have a debt over 60 % of GDP and not reduce it by 1/20<sup>th</sup> annually, even if it keeps its deficit below the 3 % reference. In its assessment, the Commission will consider 'all relevant factors and the impact of the economic cycle', which is quite a vague definition and once again leaves a vast room for interpretation for the Commission.

Moreover, the Six-Pack introduced a new mechanism, which goes beyond solely guarding the appropriate level of indebtedness - the Macroeconomic Imbalance Procedure ([MIP], Regulation (EU) 1176/2011). The Commission is empowered with both a preventive and corrective arm. The former one, which aims at *ex ante* intervention, enables the Commission to oversee the economic situation of the member state, by using a special 'scoreboard'. This scoreboard consists of 14 indicators (three new indicators regarding employment were added in 2015), a choice of which has been the subject of political bargain between the Commission, the Council and the European Parliament. However, once this regulation has been implemented, it is exclusively up to the Commission to monitor the performance of the member states. Namely, it is now empowered to carry out the so-called 'In-Depth Review'. It can do that when the chosen indicators go beyond certain thresholds. At this point, the Commission has the power to make a decision on the existence of

imbalances while ‘reviewing’ the macroeconomic situation of a given state. It is important to stress that such a mechanism gives the Commission the power to make a very interpretive verdict in its evaluation if a particular member state indeed faces a macroeconomic imbalance (Bauer, Becker and Kern 2013).

The latter mechanism, the so-called corrective arm, aiming at *ex post* intervention, is activated when a member state falls - upon decision of the Commission - into the category of the ‘Excessive Macroeconomic imbalance’. If this happens, the member state is obliged to follow recommendations in order to ‘correct’ this imbalance. Again, it is the Commission that drafts the ‘Country-Specific Recommendations’ (CRSs) for the ‘imbalanced’ member state. This procedure is called ‘Excessive Imbalance Procedure’ (EIP) and is embedded in the so-called European Semester.

The European Semester is perhaps the most important new feature introduced by the Six Pack. This is a name of the EU policy-making calendar or rather - a cycle of monitoring the fiscal and economic policies of the member states. It starts in November with the publication of the Annual Growth Survey (AGS), where the Commission sets the economic priorities of the EU for the following year. This is a crucial document, which initiates the whole process of EU economic monitoring, guidance and surveillance. Besides, it is a basis for the future CSRs that the Commission issues for every member state later on in the cycle (in May). A dialogue with the European Parliament on the AGS is conducted in December.<sup>151</sup>

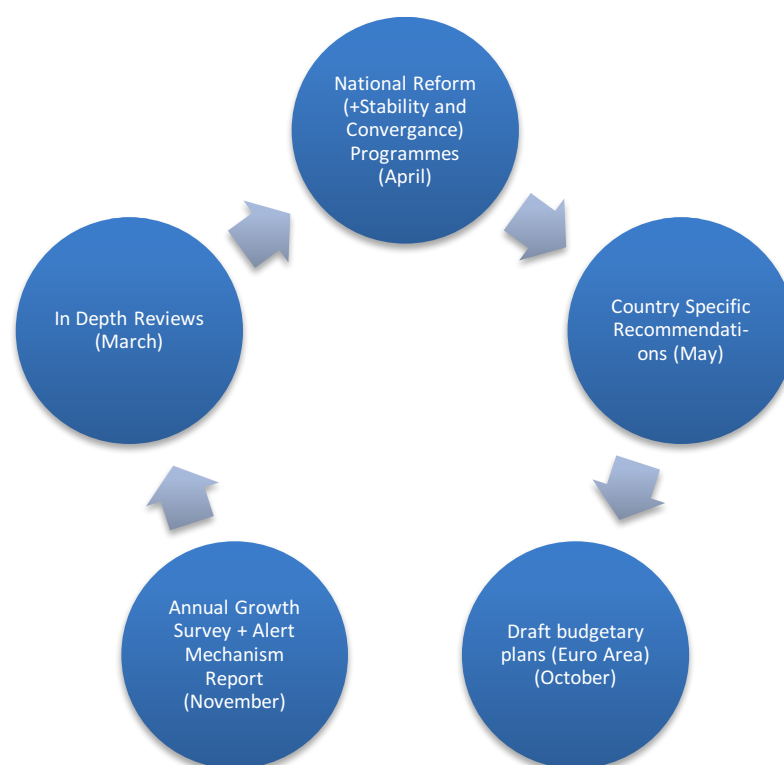
From the European Semester of 2016 onwards, the Commission publishes a special annex to the AGS with recommendations for the Euro Area countries. At the same time, the Commission publishes its Alert Mechanism Report (AMR), where the economies of the member states are analyzed in order to identify macroeconomic imbalances (for an overview of the timeline of the European Semester see Figure 1

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<sup>151</sup> European Commission, ‘The Economic Governance’, 2015 available at [http://ec.europa.eu/economy\\_finance/economic\\_governance/index\\_en.htm](http://ec.europa.eu/economy_finance/economic_governance/index_en.htm) (accessed 15 January 2017).

below). The following section on the MIP tackles the AMR in more detail. Also in November, the Commission publishes opinions on ‘draft budgetary plans’ submitted by the Euro Area member states a month earlier, which are then discussed by the Council. Significantly, only afterwards (in December) are the budgets sent to the national parliaments. The Council adopts Euro Area recommendations, as well as conclusions on the AGS and the AMR in January/February.

**Figure 1. The timeline of the European Semester**



Source: own Illustration.

The economic situation of every EU member state is presented in the Country Reports, which are published by the Commission in February. These Reports also



provide information of the existence of imbalances for countries on which an In-Depth Review was conducted.

Further, Stability Programmes, as they are called for the Euro Area members, or Convergence Programmes, as for the rest of the EU (here also the monetary policy plans are provided), are the economic plans for the next three years and are submitted every April. These documents are used by the Commission to check whether the member states are reaching their fiscal targets called the Medium-Term Budgetary Objectives (MTOs), by 'adjusting their structural budgetary positions at a rate of 0.5% of GDP per year as a benchmark'. The MTOs are based on two indicators: the structural balance analysis, as well as the expenditure benchmark.<sup>152</sup>

As a result, the MTOs are defined in 'structural terms' that are supposed to guarantee their flexibility in relation to a business cycle, and to 'filter out the effects of one-off and other temporary measures.'<sup>153</sup> The member states need to provide their budgetary plans for the next three years in order to 'ensure sound fiscal policies'<sup>154</sup>. These plans are based on 'macroeconomic forecasts produced or endorsed by independent bodies', which are then compared with the Commission's forecasts. These Stability and Convergence Programmes are then assessed by the Commission (before and after their implementation) for five purposes. First, to ensure that non-compliance is identified before it occurs. Second, to 'identify any actual instances of non-compliance that could ultimately warrant sanctions.'<sup>155</sup> Third, in order to ana-

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<sup>152</sup> European Commission, 'Stability and Convergence Programmes', 2015 available at [http://ec.europa.eu/economy\\_finance/economic\\_governance/sgp/preventive\\_arm/index\\_en.htm](http://ec.europa.eu/economy_finance/economic_governance/sgp/preventive_arm/index_en.htm) accessed 15 January 2017.

<sup>153</sup> European Commission, 'The Preventive Arm', 2015 available at [http://ec.europa.eu/economy\\_finance/economic\\_governance/sgp/preventive\\_arm/index\\_en.htm](http://ec.europa.eu/economy_finance/economic_governance/sgp/preventive_arm/index_en.htm) accessed 15 January 2017.

<sup>154</sup> European Commission, 'The Preventive Arm', 2015 available at [http://ec.europa.eu/economy\\_finance/economic\\_governance/sgp/preventive\\_arm/index\\_en.htm](http://ec.europa.eu/economy_finance/economic_governance/sgp/preventive_arm/index_en.htm) accessed 15 January 2017.

<sup>155</sup> European Commission, 'Stability and Convergence Programmes', 2015 available at [http://ec.europa.eu/economy\\_finance/economic\\_governance/sgp/preventive\\_arm/index\\_en.htm](http://ec.europa.eu/economy_finance/economic_governance/sgp/preventive_arm/index_en.htm) accessed 15 January 2017.

lyze if the MTOs were set at a proper level. Fourth, to check if a country is reaching its target. Finally, to assess if the 'economic assumptions on which governments base their [P]rogrammes are plausible.'<sup>156</sup>

Similarly, National Reform Programmes are submitted to the Commission by every EU member state. In these documents the economic policies that should lead to the strategies for growth are laid out.

The Programmes (both national reform and stability/convergence) which member states submit in April are followed by the CSRs, which are published in May. In these documents the Commission sets out its advice for the next 12-18 months for budgetary and economic policies for individual states separately on 'how to boost jobs and growth, while maintaining sound public finances' and 'to make growth stronger, more sustainable and more inclusive, in line with the EU's long-term jobs and growth plan.'<sup>157</sup>

The CSRs build on the six months of dialogue with the member states and on four documents published earlier in the cycle: the AGS from November, Country Reports from February, the member states economic and budgetary (national reform and stability/convergence) programs submitted in April, as well as from economic forecast from the beginning of May. The CSRs are discussed by the country leaders in June, followed by their official adoption in July by the EU ministers.

Both the MTOs and Stability and Convergence Programmes constitute the preventive arm of the Stability and Growth Pact (SGP), aiming at surveillance ex ante, before deficits or imbalances occur. Once they do occur, however, the SGP activates the so-called corrective arm, which the new post-2010 legislation strengthened to a

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<sup>156</sup> European Commission, 'The Preventive Arm', 2015 available at [http://ec.europa.eu/economy\\_finance/economic\\_governance/sgp/preventive\\_arm/index\\_en.htm](http://ec.europa.eu/economy_finance/economic_governance/sgp/preventive_arm/index_en.htm) accessed 15 January 2017.

<sup>157</sup> European Commission, European Commission - Fact Sheet 2015, available at [http://europa.eu/rapid/press-release\\_MEMO-15-4968\\_en.htm](http://europa.eu/rapid/press-release_MEMO-15-4968_en.htm) accessed 15 January 2017.

large extent. The Excessive Deficit Procedure (EDP) is a major building block of the corrective arm of the SGP. There are two excessive procedures in the EU: one on the deficit (EDP) and one on the imbalances (EIP). While the latter concerns a variety of economic indicators that affect the macroeconomic position of a member state, the former concerns only the level of indebtedness of a given country.

The new set of regulations enshrined mainly in the Six Pack and the Two Pack have three main goals. First, it was decided that the EU will have a right to monitor and to surveillance not only the level of deficit, i.e. the annual level of indebtedness, as the name of the procedure suggest, but that the EDP could also be triggered based on the level of debt, i.e. the total level of indebtedness, even if the deficit is below the 3 % reference value. Second, the operationalization of the debt criterion was introduced. Until the Six Pack came into force, the level of debt (as well as the level of deficit) was based on the article 126 of the Treaty on the Functioning of the European Union (TFEU), Protocol 12 on the EDP, as well as on the SGP. The limit of the debt was set at 60% of country's annual GDP and, if larger, it should be 'diminishing at a satisfactory pace'. The Six Pack operationalized the vague concept of a 'satisfactory pace' and set the concrete numerical values that the member states must meet, if their debt is above 60 % of GDP. Namely, they must diminish all the outstanding debt above the 60% value at a pace of 5% per year, i.e. 1/20<sup>th</sup> annually, on the average of three years. Otherwise, the EDP may be launched. What differentiate the deficit and debt criteria is the fact that the Commission may also activate the EDP, even if the limit of 3% value was not breached, but 'there is a risk of an excessive deficit'.<sup>158</sup> Third, for countries sharing the Euro as a currency, it is now easier to impose financial sanctions, as the relevant decision is taken by using a 'reverse qualified majority voting' procedure, which means that a sanction can be imposed by a minority of the Council.

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<sup>158</sup> 'The Commission may also prepare a report if, notwithstanding the fulfilment of the requirements under the criteria, it is of the opinion that there is a risk of an excessive deficit in a Member State' (art. 126 TFEU).

Thus, the EDP can be launched if one of the two criteria is met: the deficit level of 3 % is breached or debt is too high<sup>159</sup>, i.e. above 60% of GDP and it is not diminishing according to the new formulation.<sup>160</sup> If a member state violates one of these two criteria, the Commission should prepare a report to the Council, which serves as a basis for a decision whether to open the EDP. The Commission should take into account ‘whether the government deficit exceeds government investment expenditure’ as well as ‘all other relevant factors, including the medium-term economic and budgetary position of the Member State’ (art. 126 (3) TFEU). The Commission specifies that it particularly examines if the governments’ excessive deficit/debt was due to ‘exceptional events outside their control’, providing two examples: natural disasters and economic downturn.<sup>161</sup> Interestingly, in 2015 this formulation was used to give more leeway for countries like Italy, which had to deal with the refugee crisis.

The report of the Commission is delivered to the Council, which decides if the EDP does exist. Following a positive decision, it issues recommendations for the specific countries that ‘provide it with a concrete path for correcting its excessive deficit within a set timeframe’ - i.e. with the targets that should be met within specified deadlines. Thus, a given country is given either six or three (only when the breach

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<sup>159</sup> ‘The Commission shall monitor the development of the budgetary situation and of the stock of government debt in the Member States with a view to identifying gross errors. In particular it shall examine compliance with budgetary discipline on the basis of the following two criteria:

(a) whether the ratio of the planned or actual government deficit to gross domestic product exceeds a reference value, unless:

- either the ratio has declined substantially and continuously and reached a level that comes close to the reference value,
- or, alternatively, the excess over the reference value is only exceptional and temporary and the ratio remains close to the reference value;

<sup>160</sup> b) whether the ratio of government debt to gross domestic product exceeds a reference value, unless the ratio is sufficiently diminishing and approaching the reference value at a satisfactory pace’ (art.126 TFEU).

<sup>161</sup> ‘Special consideration can be given to countries whose fiscal positions have worsened due to exceptional events outside their control, such as in the case of natural disasters or as a result of a severe economic downturn, but under the double overarching condition that the excess over the deficit is close to the reference value and temporary.’, European Commission, ‘The Corrective Arm’, 2016, available at

[http://ec.europa.eu/economy\\_finance/economic\\_governance/sgp/corrective\\_arm/index\\_en.htm](http://ec.europa.eu/economy_finance/economic_governance/sgp/corrective_arm/index_en.htm) (accessed 15 January 2017).

was 'serious') months to take 'effective action' and comply with the recommendations. Once the deadline is passed, both the Commission and the Council examine the action the member state had taken, and may either place the EDP on hold or start it over again. Again, at this point also the 'exceptional events outside (...) control' of the government are taken into account, if the deficit or the debt was not corrected.<sup>162</sup> The difference between the Euro Area member states and the non-Euro Area members, which are placed under the EDP, is the possibility of sanctions. Under the EDP sanctions can be imposed only on the members of the currency union, while the states, which receive cohesion funds, may face suspension of these funds.

When the Euro Area country is placed under the EDP and breaks the deficit/debt ceiling in a 'serious' way; or if it was already sanctioned through the EDP; the sanctions in the form of non-interest-bearing deposit up to 0.2 % of the GDP may be imposed. If the excessive deficit is corrected, the deposit is returned to this state in the next round of assessment.

If, after the first deadline (three or six months), the Council finds that the member state did not take an effective action, it can 'step up' the procedure. 'Stepping up' takes two forms. First, it involves revised recommendations and timeframe, and then basically the whole process is repeated. Second, at this point the sanctions are strengthened and may take one of three forms:

- a.) for Euro Area members the deposit may be turn into a fine of 0.2 % of GDP
- b.) for the recipients of the cohesion funds, this type of financing may be suspended;
- c.) if the failure to correct excessive deficit repeats, the Euro Area member can face an increase of sanction of a '*variable component*' and, as a result, it can be fined up to 0.5 % of GDP, which can be imposed annually, as long as the

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<sup>162</sup> European Commission, 'The Corrective Arm', 2015 available at [http://ec.europa.eu/economy\\_finance/economic\\_governance/sgp/corrective\\_arm/index\\_en.htm](http://ec.europa.eu/economy_finance/economic_governance/sgp/corrective_arm/index_en.htm) accessed 15 January 2017.

country keeps failing to take an 'adequate action' to correct the excessive deficit, as Table 5 shows.

If the state corrects the deficit, the EDP is closed down ('abrogated').

At the time of writing (July 2017) there were six countries under the EDP, (France, the UK, Portugal, Spain, Greece and Croatia), while for the twenty member states the procedure was closed, and only for two the EDP was not opened at all (Estonia and Sweden).<sup>163</sup> The procedure proved to have limited consequences for the countries, which constantly run a deficit above the agreed 3% threshold. The most prominent example was the case of Spain and Portugal in the summer of 2016. These countries kept failing to correct the deficit, despite the recommendations of the Commission, which maintained that action is needed and the lack thereof may trigger activation of sanctions. In fact, a few days before the Commission took its decision, it was expected that the two Southern countries would be the first countries ever sanctioned by the EU. For instance, the *Financial Times* in the article titled 'Brussels set to fine Spain and Portugal for deficit breaches' insisted that 'Spain and Portugal are on course to become the first ever Euro Area countries to be sanctioned for breaching EU fiscal rules, in a move set to inflame political tensions over how dogmatic Brussels should be in policing national budgets.'<sup>164</sup> However by the decision of the Commission, which was approved by the Council, the sanctions were not imposed.<sup>165</sup>

This shows, that while the new legislation<sup>166</sup>, by introducing the reverse qualified

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<sup>163</sup> European Commission, 'The Corrective Arm', 2015 available at [http://ec.europa.eu/economy\\_finance/economic\\_governance/sgp/corrective\\_arm/index\\_en.htm](http://ec.europa.eu/economy_finance/economic_governance/sgp/corrective_arm/index_en.htm) accessed 15 January 2017.

<sup>164</sup> *The Financial Times*, 5 July 2016.

<sup>165</sup> 'Excessive deficit procedure: Council agrees to zero fines and new deadlines for Portugal and Spain', Press release of the Council, 08/08/2016, available at: [www.consilium.europa.eu/en/press/pres-releases/2016/08/08--excessive-deficit-portugal-spain/](http://www.consilium.europa.eu/en/press/pres-releases/2016/08/08--excessive-deficit-portugal-spain/) (accessed 7 February 2017).

<sup>166</sup> Specifically, the art. 7 of the Fiscal Compact, as explained in detail further down in this chapter.

majority voting mechanism, made it easier to implement them, the sanctions are still politically difficult to impose. As a result, there is a risk that the new regulations will lack necessary credibility, as was the case with the 'old' SGP. Consequently, the new rules in general, and the EDP in particular, may have limited impact on the policies of the member states, which breach the rules.

The MIP in turn, is a novel feature that was introduced by the Six Pack. It goes beyond monitoring deficit and debt levels, and consequently introduces a surveillance mechanism of the entire economies of the EU member states. It does so by using a number of indicators (14 as of February 2017) in order to detect 'imbalances' that may affect the functioning of both the individual economies and the Union as a whole. A macroeconomic imbalance is defined as 'any trend, giving rise to macroeconomic developments which are adversely affecting, or have the potential to adversely affect, the proper functioning of the economy of a Member State or of the Economic and Monetary Union, or of the Union as a whole'<sup>167</sup>. Excessive imbalances, in turn, are defined more narrowly as 'severe imbalances that jeopardise or risk jeopardising the proper functioning of the Economic and Monetary Union'.<sup>168</sup> Thus, macroeconomic imbalances may be excessive only when applied to the functioning of the EMU as a whole and not to one individual country only.

Further, the MIP, just like the SGP, has both a preventive and a corrective arm. The former consists of Council's recommendations if an imbalance is detected, while the latter may also trigger a corrective action, if the detected imbalance is 'excessive'. Another similarity to the strengthened SGP is the possibility of sanctions for the Euro Area member states. Under the MIP these sanctions can amount up to 0.1 % of GDP in the case of the lack of effective action to correct detected imbalances. The MIP feeds into the European Semester cycle. This is to guarantee that the advice

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<sup>167</sup> Art. 2 (1), Regulation 1176/2011 *On the prevention and correction of macroeconomic imbalances*.

<sup>168</sup> Regulation 1176/2011 *On the prevention and correction of macroeconomic imbalances*.

given to countries under different surveillance framework is consistent. For instance, the recommendations of the MIP are supposed to be coherent with the CSRs.

The MIP starts off in November with the publication of the Alert Mechanism Report (AMR), a 'screening device' to identify imbalances. In the AMRs, the economic situation of all the EU members is analyzed, based on the scoreboard of economic indicators. Those are of the two types: the 'headline' (with thresholds) and the 'auxiliary' (no thresholds), with the latter concerning mainly the social situation, like the level of poverty.<sup>169</sup> Importantly, the Commission takes its decisions within the MIP based on these indicators, a choice of which may be criticized, as they do not reflect the functioning of the whole economy.<sup>170</sup> As a result of such a critique, the Commission in 2015 decided to add three more to the scoreboard, which concern employment. It

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<sup>169</sup> Because of the importance of those indicators I cite them in full:

'External imbalances and competitiveness

- 3 year average of the current account balance as a percentage of GDP, with indicative thresholds of +6% and - 4%;
- net international investment position (NIIP) as a percentage of GDP, with an indicative threshold of -35%; the NIIP shows the difference between a country's external financial assets and its external financial liabilities;
- 5 years percentage change of export market shares measured in values, with an indicative threshold of -6%;
- 3 years percentage change in nominal unit labour cost(ULC), with an indicative thresholds of +9% for euro area countries and +12% for non-euro area countries.
- 3 years percentage change in real effective exchange rates(REER) based on HICP deflators, relative to 41 other industrial countries, with indicative thresholds of -/+5% for euro area countries and -/+11% for non-euro area countries; the REER shows price competitiveness relative to the main trading partners.

Internal imbalances

- private sector debt (consolidated) as a percentage of GDP, with a threshold of 133%;
- private sector credit flow as a percentage of GDP, with an indicative threshold of 15%;
- year-on-year percentage change in deflated house prices, with an indicative threshold of 6%;
- public sector debt as a percentage of GDP with an indicative threshold of 60%;
- 3-year average of unemployment rate, with an indicative threshold of 10%;
- year-on-year percentage change in total financial liabilities of the financial sector, with an indicative threshold of 16.5%', European Commission, 'European Commission - Fact Sheet Fourth Alert Mechanism Report on macroeconomic imbalances in EU Member States', 2014 available at [http://europa.eu/rapid/press-release\\_MEMO-14-2231\\_en.htm](http://europa.eu/rapid/press-release_MEMO-14-2231_en.htm) accessed 15 January 2017

<sup>170</sup> Savage, J. (2016), 'Enforcing the European Semester: The Politics of Asymmetric Information in the Excessive Deficit and Macroeconomic Imbalance Procedures': 14, available at <http://www.nias.knaw.nl/news-events/calendar/workshop-events/workshop-papers-eu-decision-making/Savage%20Paper%20Enforcing%20the%20European%20Semester.pdf> (accessed 28 August 2017).



did so in order to 'better take into account the analysis of employment and social developments'.<sup>171</sup> As a consequence, the following indicators have been added to the group of 'headline' indicators (they are 'obligatory', with thresholds that the member states must respect): (i) activity rate ('The activity rate is defined as the number of active population (employed and unemployed) over total population (i.e. more precisely, the denominator represents the working-age population)', computed over a 3-year period, with a threshold of -0.2 %; (ii) long-term unemployment ('the number of unemployed for 1 year or more as a percentage of the active population', computed over a 3 years period, with a threshold of 0.5 % and (iii) youth unemployment ('percentage of young unemployed aged 15-24 over active population', computed over 3-year period, with a threshold of 2 %).<sup>172</sup> Before 2015 these social indicators also existed in the scoreboard, but only as the 'auxiliary' ones.

The next stage of the European Semester consists of the 'In-Depth Reviews' (IDRs). The IDRs are prepared for a detailed analysis of countries with a risk of imbalance, as identified in the AMR. The Commission asserts that the AMR is not meant to be a 'mechanical exercise', in which going beyond certain threshold activates the IDR. Rather, the whole economic situation (so the Commission claims) is taken into account, also at the later stage while deciding whether the identified imbalance is 'excessive'.

The AMRs are discussed by the Economic and Financial Affairs Council (ECOFIN), followed by their official publication by the Commission. From 2015 onwards, once published, the IDRs are part of the Country Reports, prepared by the Commission

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<sup>171</sup> European Commission, 'Adding Employment Indicators To The Scoreboard Of The Macroeconomic Imbalance Procedure To Better Capture Employment and Social Developments', 2014 available at

[http://ec.europa.eu/economy\\_finance/economic\\_governance/documents/employment\\_indicators\\_mip\\_en.pdf](http://ec.europa.eu/economy_finance/economic_governance/documents/employment_indicators_mip_en.pdf) accessed 15 January 2017, p. 1.

<sup>172</sup> European Commission, 'Adding Employment Indicators To The Scoreboard Of The Macroeconomic Imbalance Procedure to Better Capture Employment and Social Developments', 2014 available at

[http://ec.europa.eu/economy\\_finance/economic\\_governance/documents/employment\\_indicators\\_mip\\_en.pdf](http://ec.europa.eu/economy_finance/economic_governance/documents/employment_indicators_mip_en.pdf) accessed 15 January 2017, p. 11.

for all the EU member states. The ECOFIN (or Euro group, if the concerned country is a Euro Area member), then takes a decision, based on the IDR, on any further steps the Commission should take, with starting the Excessive Imbalance Procedure (EIP) as the most serious action.<sup>173</sup> The IDRs 'feed into' the analysis of the Country Specific Recommendations. As from November 2015 onwards, when the AMR 2016 was published, a special section on the Euro Area is added in order to 'conduct a more systematic analysis of euro area-wide implications of countries' imbalances and how such implications require a coordinated approach to policy responses.'<sup>174</sup>

As a result, the analyzed country falls into one of four categories:

1. 'No imbalances,
2. Imbalances,
3. Excessive imbalances
4. Excessive imbalances, with corrective action, which may lead to the Excessive Imbalance Procedure'<sup>175</sup>

The category numbered 2 is part of the preventive arm of the MIP, and is activated when an imbalance is detected, while the categories 3 and 4 constitute the corrective arm and can be applied to countries, whose imbalances are excessive.<sup>176</sup> It is worth

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<sup>173</sup> European Commission, 'The start of the 2016 European Semester: The November European Semester package explained', 2015 available at [http://ec.europa.eu/economy\\_finance/publications/occasional\\_paper/2015/op228\\_en.htm](http://ec.europa.eu/economy_finance/publications/occasional_paper/2015/op228_en.htm) accessed 15 March 2017.

<sup>174</sup> European Commission, 'The start of the 2016 European Semester: The November European Semester package explained', 2015 available at [http://ec.europa.eu/economy\\_finance/publications/occasional\\_paper/2015/op228\\_en.htm](http://ec.europa.eu/economy_finance/publications/occasional_paper/2015/op228_en.htm) accessed 15 March 2017.

<sup>175</sup> European Commission 2017, 'In-depth reviews' available at [https://ec.europa.eu/info/business-economy-euro/economic-and-fiscal-policy-coordination/eu-economic-governance-monitoring-prevention-correction/macroeconomic-imbalance-procedure/depth-reviews\\_en](https://ec.europa.eu/info/business-economy-euro/economic-and-fiscal-policy-coordination/eu-economic-governance-monitoring-prevention-correction/macroeconomic-imbalance-procedure/depth-reviews_en) accessed 15 February 2017

<sup>176</sup> Before 2017, there were six categories, the previous 1<sup>st</sup> and 6<sup>th</sup> categories are equivalents of the present 1<sup>st</sup> and 4<sup>th</sup>, respectively. European Commission, 'MIP reports', 2016 available at

noting that in both 2014 and 2015 no country fell into either the 1<sup>st</sup> or the 4<sup>th</sup> category.<sup>177</sup> In the AMR of 2015 there were sixteen member states for which the Commission conducted the IDR, while in 2016 this number increased to eighteen.<sup>178</sup> For most countries, however, the IDR was conducted in order to check if the imbalances identified a year before have been corrected. Nevertheless, the total number of countries under the in-depth surveillance amounted to twenty, because of Greece and Cyprus, whose economic situation was assessed in the framework of their respective financial assistance programs. Only eight member states in the 2016 economic cycle did not require the in-depth review (the Czech Republic, Denmark, Latvia, Lithuania, Luxembourg, Malta, Poland and Slovakia).<sup>179</sup>

The Council may launch the new Excessive Imbalance Procedure (EIP), if the Commission in its in-depth review finds out that an excessive imbalance exists. In such a case, the concerned member state is asked to present a detailed Corrective Action Plan (CAP) with deadlines for specific policy measures it is obliged to take in order to correct existing excessive imbalances. The required policy actions may affect many macroeconomic policies that are subject of surveillance under other procedures within the European Semester. This is especially true for fiscal policy, as many of the macroeconomic decisions have an impact on the national budgets.

For this reason the EIP is also ‘embedded’ in the European Semester to assure consistency and coherence of policy response across surveillance mechanisms. Once the

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[http://ec.europa.eu/economy\\_finance/economic\\_governance/macroeconomic\\_imbalance\\_procedure/mip\\_reports/index\\_en.htm](http://ec.europa.eu/economy_finance/economic_governance/macroeconomic_imbalance_procedure/mip_reports/index_en.htm) accessed 15 March 2017.

<sup>177</sup> The MIP is not be confused with the EDP, which was not opened for Estonia and Sweden.

<sup>178</sup> European Commission, ‘Macroeconomic Imbalances. Main Findings of the In-Depth Reviews 2015’, 2016 available at [http://ec.europa.eu/economy\\_finance/publications/occasional\\_paper/2015/op228\\_en.htm](http://ec.europa.eu/economy_finance/publications/occasional_paper/2015/op228_en.htm) accessed 15 March 2017.

<sup>179</sup> European Commission, ‘The start of the 2016 European Semester: The November European Semester package explained’, 2015 available at [http://ec.europa.eu/economy\\_finance/publications/occasional\\_paper/2015/op228\\_en.htm](http://ec.europa.eu/economy_finance/publications/occasional_paper/2015/op228_en.htm) accessed 15 March 2017.

CAP is submitted, the Council assesses its potential efficiency and, following a positive decision, it will 'endorse the CAP through a recommendation' with the concrete policy actions and a timetable.<sup>180</sup> If the CAP is accepted, then the Council checks if it was implemented. An interest-bearing deposit may be imposed if a country fails to deliver the agreed policy actions, which may be turn into fine in the case of a second failure of implementation. The procedure is put in 'abeyance' once the policy actions agreed in the CAP are taken, and is closed, once the excessive imbalances disappear.

Furthermore, the EIP introduced a possibility of financial sanctions for a non-compliance with its recommendations. Significantly, however, these sanctions can be imposed only based on the assessment of the actions taken by of the concerned member state, and not based on their effectiveness - i.e. not on the fact that the imbalance still exists. The member state can submit the CAP twice, and if for the second time the Council finds it 'insufficient' it may impose a fine of 0.1% of GDP.

### The Fiscal Compact

The 'Treaty on Stability, Coordination and Governance in the Economic and Monetary Union', the so-called Fiscal Compact (FC) was signed in Brussels on 2 March 2012. Initially intended as part of EU law, to strengthen the Stability and Growth Pact, it lacked the required unanimity among the member states, when the UK and the Czech Republic refused to sign it. During the debate in the House of Commons, David Cameron, the British Prime Minister, claimed that he refused to sign the Fiscal Compact in order or protect British national interest. Specifically, he claimed that Britain did not receive proper safeguards on the single market and on financial

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<sup>180</sup> European Commission, 'MIP framework ', 2016 available at [http://ec.europa.eu/economy\\_finance/economic\\_governance/macroeconomic\\_imbalance\\_procedure/mip\\_framework/index\\_en.htm](http://ec.europa.eu/economy_finance/economic_governance/macroeconomic_imbalance_procedure/mip_framework/index_en.htm) accessed 15 March 2017.

services. The details of those safeguards remained unknown.<sup>181</sup> Cameron went on to argue that: '(...) I have to tell the House that the choice was a treaty without proper safeguards or no treaty—and the right answer was no treaty.'<sup>182</sup> As a result, it was signed as an international treaty by the remaining 25 member states.

The FC requires its Contracting Parties to maintain a 'balanced budget rule' and its art. 3(1) provides its detailed specification. The following paragraph, the Article 3 (2), in turn, specified a method of its implementation:

*The rules set out in paragraph 1 shall take effect in the national law of the Contracting Parties at the latest one year after the entry into force of this Treaty through provisions of binding force and permanent character, preferably constitutional, or otherwise guaranteed to be fully respected and adhered to throughout the national budgetary processes.*

Thus, the FC obliges the states to implement a balanced budget rule into their national, preferably constitutional, law. The states, which failed to do so, may be sanctioned with a fine up to 0.1% of GDP imposed by the European Court of Justice (ECJ), which is quite unusual for the international agreement (F. Fabbrini 2013). Remarkably, the fines from the Euro Area countries would be transferred to the ESM, while sanctions imposed on the non-Euro Area state would be transferred to the general EU budget. In this regard, the ESM could be seen as an equivalent of the EU budget.

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<sup>181</sup> Hancox (2014) 'Constitutional Change through Euro Crisis Law: "United Kingdom"', European University Institute, Department of Law, available at <http://eurocrisislaw.eui.eu/uk/> (accessed 29 August 2017).

<sup>182</sup> House of Commons Hansard, 12 December 2011, <https://publications.parliament.uk/pa/cm201011/cmhansrd/cm111212/debtext/111212-0001.htm#1112127000001> (accessed 29 August 2017).

As a result, the FC ensures the compliance with its fiscal straightjacket (the so-called golden rule, which put a maximum ceiling of the structural deficit at 0.5 % of GDP, as indicated in the Art. 3) by imposing on the Contracting Parties an obligation to implement the golden rule into domestic law. When it happens, it can work 'as a benchmark for the constitutional review of budgetary laws' (F. Fabbrini 2013: 6). Hence, the compliance with the provisions of the FC was secured. Moreover, authors of the FC secured a provision, which allowed it to come into force more easily, even without the ratification of all the contracting parties. Namely, it was decided that the FC enters into force after ratification of the twelve states of the Euro Area and not all 25 contracting states. It has been argued that the EU has a federalist deficit (Trechsel 2005). This provision of the FC is an example of overcoming this deficit by abandoning the unanimity rule. Significantly, it was possible because of the international character of the FC.

The FC is also connected with the European Semester. Specifically, its art. 7 strengthens the role of the Commission within the Excessive Deficit Procedure: its recommendations are now quasi-automatic for the Euro Area countries - the qualified majority of the Council will have to vote against sanctions in order to overcome them. Interestingly, as a result a fine for breaching the deficit criterion can be imposed by the *minority* of the Council<sup>183</sup>.

To sum up, the European Semester is a policy coordination cycle that was introduced in 2011 as a tool of coordinating (or rather - regulating) fiscal (as enshrined in the SGP) and economic (via new macroeconomic imbalance procedure) policies of the EU member states. It was introduced because of the possibility of the spill-over of economic policies conducted in one country to the other member states. The chosen model of regulation of fiscal policies of the member states was meant to prevent accumulation (or even - the existence) of economic imbalances and budget deficits

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<sup>183</sup> Despite of what its official name ( 'reverse qualified majority voting') could suggest.

that could have the negative effects on the other member states and the functioning of the EU as a whole. For this reason a complicated system of recommendations, benchmarks and rules was introduced. This system is based on a solid legal framework, which introduced the possibility of financial sanctions, that could be imposed on the countries that do not comply with the EU recommendations.

However, despite the enforced legal basis and a threat of sanctions, the implementation of the European Semester has proved to be rather weak. It has been shown that the overall implementation of EU recommendations in 2014 was at a rate of just 29 %. To this end, the chosen path of regulation of fiscal and economic policies has three main limitations (Darvas and Leandro 2015). First, the implementation rate of the Euro Area countries was also quite low (31 %<sup>184</sup>), and for the non-Euro Area countries it was even lower (23 %). What is more, for both groups the implementation rate has declined since 2011 (40% at the time). Second, while the implementation of SGP rules was higher (44 % in 2012-2014 average) than those concerning macroeconomic imbalances (32% in 2012-2014 average) and other recommendations (29%), this rate is also rather low, especially if one takes into account a much stronger legal basis of the SGP rules, including the threat of sanctions.

Third, the Country Specific Recommendations, in which the Commission advises the concrete policy actions for the individual countries, should reflect the Euro Area recommendation of ‘certain tangible economic goals’ that is endorsed by the Council. However, there is a high degree of inconsistency - the CSRs do not reflect well the Euro-Area recommendations of the Council in all but one category<sup>185</sup> (Darvas and Leandro 2015: 10-14).

What is more, one observes a surprising disappearance from the 2015 Council recommendations of a remark on the need to correct both the deficits and the surplus-

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<sup>184</sup> The numbers for implementation rate come from the study conducted by Darvas and Leandro (2015).

<sup>185</sup> The exception being reform service markets.

es, as both constitute imbalances, which may have spill-over effects on the other members of the monetary union. In this regard, Germany, because of its size and trade connections with the rest of the monetary union, is a particular case, because it continues to run large surpluses. However, because of the disappearance of the need to correct these imbalances from the Council's recommendations for the Euro Area, the CSRs from 2015 also do not mention such a need, which may be seen as an evidence of unequal treatment of the member states (Darvas and Leandro 2015: 14-15).

Therefore, the way the European Semester was implemented shows the limitations of regulating fiscal policies of the member states, which was an instrument of integration the EU has chosen instead of fiscalization. It has a limited effect on the fiscal and economic policies of the member states. But at the same time this instrument of integration creates a challenge for democratically elected governments. Namely, the area of discretion for the national governments has been limited, while more leeway for the decisions regarding domestic policymaking was given to the Commission, as I show below.

The Commission seems to have the largest 'discretionary space' in the framework of the Country Specific Recommendations (which can be seen the EU's 'micro-interventions' in domestic policymaking), as well as in the two procedures: the Excessive Deficit Procedure and the (Excessive) Macroeconomic Imbalance Procedure (Dawson 2015). Within these Procedures financial sanctions for the Euro Area member states can be imposed in the case of non-compliance with the Commission's recommendations. These sanctions are summarized in Table 5 at the beginning of this chapter. As a result, the EU not only strengthened the rules regulating the fiscal policies of its member states, but also introduced a mechanism of 'micro-intervention' of domestic policy making. Consequently, the EU has blurred the boundaries between the responsibilities of the member states and those of the EU. As a result, the EU encroached on the fiscal policy, always regarded as the 'core



power' of the states (Genschel and Jachtenfuchs 2013), and thus has put limits on the member states' sovereignty in this respect.

In assessing the complex mechanisms of the new economic governance of the EU, it is useful to realize that when a country is hit by an asymmetric economic shock its government normally has a significant room of maneuver for discretionary spending in order to boost the economy. However, the new fiscal governance of the EU makes it much more difficult, as it introduces stricter limits on deficits and debts of the member states. In a monetary union such a possibility of countercyclical fiscal policy is essential, because its member states cannot affect the economy by using monetary policy, which is centralized in the common independent central bank. As a consequence, a country hit by a shock cannot devalue its currency in order to make its economy more competitive. When a monetary union is hit by a symmetric economic shock, for instance by an economic crisis that affects all the members equally, it should be able to accommodate such a shock by monetary means. However, if this shock is asymmetric, i.e. it hits only some member states, than it is impossible to do that, since a monetary policy can be only one. In this scenario, a fiscal policy at the central level could come into play in order to compensate the states that do not benefit from the current monetary policy.

For example, if one country is experiencing an economic recession and high level of unemployment, it would be beneficial for this country if the central bank, the ECB in the EU case would conduct expansionary monetary policy, i.e. to lower the interest rates and hence to make borrowing money cheaper. This, in principal, would encourage companies to invest as they could have access to a cheap credit. There is one problem, however, if the interest rates are so low that they reach, or are close to reaching, a zero bound - this is a limit to traditional monetary policy. We could observe such a situation during the financial crisis in both the US and the EU. Their central banks, the Federal Reserve (Fed), followed by the ECB, reacted by conduct-

ing so called unconventional monetary policy, mainly in the form of quantitative easing, i. e. buying bonds from commercial banks.

Contractionary monetary policy, on the other hand, aims mainly at addressing inflation by raising the interest rates and consequently making borrowing money more expensive, which transforms into the level of interest rates the commercial banks charge individuals and firms. The mandate of the ECB has been to keep inflation low ('below, but close to, 2 % over a medium term'), however this is not the only objective a central bank can pursue. The Fed, for instance, is obliged to keep both the inflation and the level of unemployment low. In Maastricht, however, it was decided that the ECB will follow the mandate of the Bundesbank, which is concerned only about inflation.

As one can see, when it comes to the economic growth in a monetary union, especially at the time of inflation close to zero and low interest rates, it could be more effective if monetary policy would be accompanied by fiscal means of the central level - fiscalization. Such a combination of monetary and fiscal policies is called the 'policy mix'.

The mechanisms described so far, however, represent regulation of the fiscal policies of the EU member states, which was a dominant instrument of integration that EU has followed since 2010. Nonetheless, some initiatives in the area of fiscalization were also undertaken, a topic I turn to in the following section.

### 5.2.3 *Quasi-fiscalization*

While the main instrument of integration that the EU implemented in its response to the Euro crisis was fiscal regulation, as I demonstrated in the previous section, the EU also created a number of mechanisms that represents, what I call, a quasi-fiscalization process. I used the word *quasi*, because those mechanisms cannot be regarded as part of fiscalization per se according to the definition I proposed in Chapter 2.3. It is mainly due to the fact that the EU was not given an independent source of revenue. These mechanisms, which I discuss below, are: the EU as a borrower and the European Stability Mechanism.

#### The EU as a borrower

I will show that the EU, while lacking the power to tax, does have a second component of the fiscal power - a borrowing power. The way the borrowed money could be used is strictly limited - the funds can only be lent to the member states on the back-to-back basis and cannot be used to finance the deficit of the EU. Nonetheless, one should not underestimate the relevance of having such a power. As I will argue, the EU lending mechanisms (Balance of Payment [BoP] and European Financial Stabilisation Mechanism [EFSM]) have a borrowing capacity of 110 billion euros, which comes close to the annual EU budget (132,8 billion euro in payments in 2013). Additionally, the intergovernmental European Stability Mechanism (ESM) has the paid-in capital of circa 80 billion and a lending capacity of 700 billion, around 5 % of the EU GDP. As noted in the previous chapters, there are many scholars who advocate the creation of the EU fiscal union with the tax, spending and borrowing powers (see, e.g., De Grauwe and Ji 2014: 32; Eichengreen 1991: 25-26). While it is true

that the EU does not have the tax power, it does have a borrowing power, which constitutes one part of a fiscal power, next to the taxing and spending powers.

Consequently, the EU can borrow funds on the markets and it has a credit rating assessed by four major credit rating agencies. It can issue debt under three schemes: the EFSM, the Balance of Payment and the Macro-Financial Assistance (MFA). The focus of this section will be mainly on the first scheme, as the creation of EFSM was directly connected to the Euro crisis. The remaining two schemes, nevertheless, also provide a legal framework under which the EU can borrow significant amounts of funds. The aim of the first one, the BoP, is to provide credit to the non-Euro Area members and it has a ceiling of 50 billion euros. In total BoP constitute 10.3 % of all outstanding loans from the EU and was utilized for Romania, Hungary and Latvia. The second scheme, the MFA, targets 'partner countries currently following an IMF programme.'<sup>186</sup> Although it has no ceiling, the use of this form of financial aid was limited: in 2015 it was used to provide loans mainly to Ukraine (4% of all outstanding EU loans), but also other countries (only 1.4% of all outstanding EU loans) and as of December 2015 there were 3.01 billion euros in outstanding loans under the MFA. The EU also preforms loans to the Euratom and the European Steel and Coal Community in Liquidation, but those do not exceed 1% of EU's total borrowing. Importantly, the EU does not have a capacity to lend from its budget - in order to lend, the EU has to borrow on the markets first.

The largest portion of the EU borrowing capacity is utilized under the EFSM. Significantly, this mechanism was created in May 2010 by the Council Resolution 407/2010, which used art. 122 (2) of the TFEU, which states:

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<sup>186</sup> European Commission, 'The EU as a Borrower', 2015, available at [http://ec.europa.eu/economy\\_finance/eu\\_borrower/index\\_en.htm](http://ec.europa.eu/economy_finance/eu_borrower/index_en.htm) (accessed 15 February 2017).

*Where a Member State is in difficulties or is seriously threatened with severe difficulties caused by natural disasters or exceptional occurrences beyond its control, the Council, on a proposal from the Commission, may grant, under certain conditions, Union financial assistance to the Member State concerned. The President of The Council shall inform the European Parliament of the decision taken.*

It remains problematic to regard the economic situation of Portugal or Ireland - to which the financial assistance under the EFSM was provided by using this article of the TFEU - equal to a natural disaster, or if it was beyond the control of these countries. Hence, the use of Art. 122 TFEU was quite controversial. This controversy notwithstanding, it is a clear evidence that the situation at that time amounted to a threat, as outlined in Chapter 2.4, to which the EU had to respond. While this threat was not large enough to trigger fiscalization of the EU, it was strong enough to trigger the process of quasi-fiscalization.

As mentioned earlier, the main element of the EU lending mechanism is the EFSM, which constitutes 84.3 % of all outstanding EU loans and was utilized just for two countries: Portugal (43.8%) and Ireland (40.5%).<sup>187</sup> However, the EFSM was also activated for other countries, for instance in July 2015 when 7.16 billion euros was lent to Greece, after weeks of contested disputes with the Greek government. This loan had three months of maturity and was provided as a 'bridge-loan', until the financing from the ESM was activated.

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<sup>187</sup> European Commission, 'Investor Presentation' 2016 available at [http://ec.europa.eu/economy\\_finance/eu\\_borrower/documents/eu\\_investor\\_presentation\\_en.pdf](http://ec.europa.eu/economy_finance/eu_borrower/documents/eu_investor_presentation_en.pdf), p. 18, accessed 15 February 2017.

As a result, some member states outside the Euro Area worried about their liability in case of a Greek default. Consequently, the Council in its decision to provide this Greek loan asserted that any future use of the EFSM would be made in a way, which would guarantee that the non-Euro Area countries would not take any risk in the case of default of the beneficiary state.<sup>188</sup> However, even in the case of this Greek loan, which was provided under strict conditionality of the macroeconomic policy reforms, safeguards were provided for non-Euro Area countries to ‘ensure that non-euro area member states do not carry any risk’. Accordingly, any liabilities for those countries, in the case of Greek default, will be ‘immediately reimbursed.’<sup>189</sup>

In total, at the end of 2015 the EU had a debt of 54 billion in outstanding bonds, and a lending capacity of 110 billion under two programs: EFMS (60 billion) and BoP (50 billion). The MFF has no ceiling of its lending capacity. The maturity of loans ranges from 5 to 30 years.

A collateral for the EU debt is its budget, which is established for a seven-year period under the Multiannual Financial Framework (MFF). Consequently, the budgetary margins, i.e. the difference between annual current annual budgetary ceiling and the total budget for seven years, serve as a protection for the investors, in the

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<sup>188</sup> ‘The Commission and the Council agree that any future use of the EFSM Regulation or any other instrument of a similar nature, for the purpose of safeguarding the financial stability of a Member State whose currency is the euro, will be made conditional upon arrangements (via collateral, guarantees or equivalent measures) being in place which ensure that no financial (direct or indirect) liability will be incurred by the Member States which do not participate in the single currency. In order to reflect this principle, the Commission will make a proposal for the appropriate changes to the EFSM Regulation as soon as possible, which shall be agreed in any case before any other proposal for support under the EFSM Regulation is brought forward. Moreover, the Commission commits not bringing forward any proposal for the use of the EFSM without a mechanism for the protection of the Member States whose currency is not the euro being assured’, European Council, *Joint declaration by the Commission and the Council on the use of the EFSM*, available at <http://data.consilium.europa.eu/doc/document/ST-10994-2015-INIT/en/pdf>, accessed 22 January 2017

<sup>189</sup> European Council, *EFSM: Council approves €7bn bridge loan to Greece*, available at <http://www.consilium.europa.eu/en/press/press-releases/2015/07/17-efsm-bridge-loan-greece/>, accessed 22.01.2017.

case of a default of a state that the EU lent to. As such, the EU debt is lent to a country on a back-to-back basis - a beneficiary country must pay back the whole sum together with the interest to the EU, which must then pay it back to its creditors. In principle, the EU is not lending money from its budget, but it is somehow 'lending' its credit rating, which is based not only on the EU budget, but also on the credit ratings of the biggest net payers to this budget. I will demonstrate it further down by analyzing the Standard's & Poor (S&P) credit rating, where this major credit rating agency decided to lower the EU rating.

The EU bonds are the obligation of the EU, and as such the interest paid on them reflects the credit rating of the EU, and not of the countries where the money is finally distributed.<sup>190</sup> Back in 2015 the EU enjoyed a credit rating of triple A (AAA/Aaa with a stable outlook), i.e. the highest one, from three rating agencies (Fitch Ratings, Moody's and DBRS); while the S&P was the only agency at that time, which lowered the EU's rating to AA+ with a negative outlook. In its report, S&P attributed this assessment to the credit deterioration of France and the UK. It stated that those two countries, together with Germany, provide more than 70% of net contributions to the EU, and consequently, S&P in assessing creditworthiness of the EU decided to base its judgment on the credit rating of those three states. It did so because of the lack of paid-in capital of the EU, which differentiates the EU from other multilateral lending organizations. Remarkably, paid-in-capital exists in the case of the ESM, which will be assessed in the following section.

In the final remarks of its report, S&P laid out four criteria that it will take into account in the future assessment of the EU's credit rating: 'sovereign creditworthiness of net contributing EU sovereigns deteriorated, if we considered future budgetary negotiations to be more protracted and acrimonious than past negotiations, if mem-

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<sup>190</sup> 'Investing in an EU bond is purely linked to the credit quality of the EU and entirely unrelated to the credit risk of the related EU loan to a beneficiary country.', European Commission, 'The EU as a Borrower', 2015, available at [http://ec.europa.eu/economy\\_finance/eu\\_borrower/index\\_en.htm](http://ec.europa.eu/economy_finance/eu_borrower/index_en.htm) (accessed 11 February 2017).

bers applied to leave the EU, or if its financial measures deteriorated'.<sup>191</sup> As a result, the credit of the EU heavily depends on the fiscal stance of its members, including the UK, and most probably will be further downgraded, as a result of the British referendum of 2016, in which the UK decided to leave the EU.

Within the EFSM all EU member states are responsible for the debt that the Commission acquires under this Mechanism. For instance, in a case of a withdrawal of a country from the EU, it is unlikely that such country would still be reliable for the debt of an organization it decided to leave. This is not a purely abstract debate, since the UK, the third biggest net payer to the EU budget, decided to leave the EU. As a result, the credit of the EU is likely to deteriorate, as the S&P report anticipated. One may also wonder what happens for the UK if Portugal and Ireland will default on their debts from the EFSM. The current MFF is likely to be insufficient to pay back creditors what the EU has borrowed. In such scenario, the Commission would have to draw 'directly from the resources of the member states'. At least, this is what the Commission asserted the potential creditors, in its 'Investor's presentation'. This presentation was created in order to convince the potential investors that the EU is creditworthy and therefore buying its bonds is a safe investment:

'In addition, should the funds available from the EU budget be insufficient, the Commission may directly draw on the Member States, *without any extra decision making being required*. '<sup>192</sup> (italics added).

This is quite a bold statement by the Commission, and one may wonder what the position of the Council would be if it was informed that 'no extra decision making' is necessary in order to allocate more funds from the member states in order to pay

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<sup>191</sup> Research Update: European Union Supranational Outlook Revised To Negative; 'AA+/A-1+' Ratings Affirmed, [http://www.standardandpoors.com/en\\_US/web/guest/article/-/view/sourceId/9273715](http://www.standardandpoors.com/en_US/web/guest/article/-/view/sourceId/9273715) accessed on 22.01.2017.

<sup>192</sup> European Commission, 'Investor Presentation' 2016 available at [http://ec.europa.eu/economy\\_finance/eu\\_borrower/documents/eu\\_investor\\_presentation\\_en.pdf](http://ec.europa.eu/economy_finance/eu_borrower/documents/eu_investor_presentation_en.pdf), p. 18, accessed 07 February 2017, p. 8.



back the EFSM debt. In this presentation, the Commission also referred to the Articles 310 and 323 of the TFEU. Although the former describes the EU budget and the way it could be financed, it contains one paragraph, which can potentially be contrary to the above cited statement for the investors. It reads as follows:

*With a view to maintaining budgetary discipline, the Union shall not adopt any act which is likely to have appreciable implications for the budget without providing an assurance that the expenditure arising from such an act is capable of being financed within the limit of the Union's own resources and in compliance with the multiannual financial framework referred to in Article 312.*<sup>193</sup>

It means that the Commission cannot issue legal acts that may potentially create expenditures that it will not be able to finance from its own budget, which is different to what it claimed, in the presentation.<sup>194</sup>

Meanwhile, the art. 323 of the TFEU, also cited in the Commission's presentation, indeed provides that 'financial means are made available to allow the Union to fulfil its legal obligations'<sup>195</sup>. However, it does not mention member states at all, but only the EU institutions: the European Parliament, the Council and the Commission. Clearly, investors are aware that the Commission, unlike any other government, is not a sovereign (public bonds are usually issued by the governments with the sovereignty over tax, thus the name 'sovereign bonds') in the fiscal domain, it cannot have a deficit and does not have a power to tax. The EU's own sources of revenue consist of just about a fifth of the overall budget, which is based on the MFF. This framework is negotiated between the member states every seven years. For this rea-

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<sup>193</sup> Art. 310, para. 4 of TFEU.

<sup>194</sup> Especially with the already mentioned claim, that in the case the EU budget is not sufficient to cover its obligations, the Commission may 'draw on the Member States, without requiring any extra decision-making.'

<sup>195</sup> 'The European Parliament, the Council and the Commission shall ensure that the financial means are made available to allow the Union to fulfil its legal obligations in respect of third parties.'

son investors may fear that in the case of problems with paying back its debt, the Commission may not be able to raise additional funds (as bonds cannot be used to cover deficit). However, the Commission may use art. 323 as a way to transfer its debt onto the member states and to argue that the Council, by agreeing on the EFSM, has created a legal obligation for the third parties and therefore this article can be applied.

In conclusion, even though the size of the EFSM is too small to provide for an effective backstop for the systemic risks in the EU, it is a significant 'leap forward' in building the fiscal capacity of the EU for the following reasons. First, notwithstanding its insufficient size to accommodate asymmetric shocks, with the 60 billion euros lending ceiling it nevertheless constitutes almost half of the annual EU budget. In fact, a report issued by the ECB assessed the EFSM as 'fairly far-reaching form of pooling of fiscal resources'.<sup>196</sup> Second, the EFSM is ruled by the Council by using majority voting - the decisions to activate funds are taken by the official EU institution, using EU rules of decision-making. Therefore, the nature of the EFSM is supranational as opposed to the intergovernmental set-up of the ESM, the institution which was created, when it was clear that the EFSM's 60 billion euros is not enough to prevent some Euro Area member states from defaulting on their debts, as I demonstrate in the following section.

## European Stability Mechanism (ESM)

When it became clear the lending capacity of the EFSM is not sufficient, the member states of the Euro Area decided that a larger lending institution has to be created. It

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<sup>196</sup> 'Notwithstanding its relatively limited financial envelope, this is considered to be a significant step in terms of integration, as a decision regarding the activation of the EFSM facility can be taken by qualified majority in the Council, and it implies a fairly far-reaching form of pooling of fiscal resources.' (Dorucci et al. 2015: 32-33).

was done in two stages and outside the EU law. First, in June 2010 the European Financial Stability Facility (EFSF) was created, which was a temporary intergovernmental organization with a lending capacity of 440 billion euro. It still exists as a legal entity, but cannot make any new loans. Second, in October 2012, its permanent successor was created - the ESM. This is an international organization based on an international treaty and located in Luxembourg (de Witte 2012). It is a rescue fund, which can be used when a country of the Euro Area falls into financial difficulties. Its budget composes of the contributions from the countries which signed the Treaty Establishing the European Stability Mechanism (TEESM) and its lending capacity, together with the EFSF, is 700 billion euro.

Both the EFSF and the ESM have a number of features that differentiate them from the EU's mechanism in the form of the EFSM. First, these two institutions are completely detached from the EU budget. The annual EU budget is five times smaller than the lending capacity of the ESM. This budget in 2013 amounted to 132, 8 billion euro in payments (150,9 billion euro in commitments) and hence it is insufficient in dealing with governments facing financial difficulty. Second, both institutions serve only the Euro Area countries and not the whole EU (for instance, the much smaller financial institution based on the EU Treaties and on the EU budget - the EFSM can be utilized for every member of the EU, its lending capacity is around eleven times smaller than the one of the ESM). Third, the contribution key to both the guarantees scheme of the EFSF and the capital of the ESM is based on the same criteria as the paid-in capital of the ECB, which take into account two indicators - GDP and population. Interestingly, both institutions can make profit that will then be distributed among shareholders. Admittedly, they are exposed to risk but also to potential profit.

Therefore, the ESM is a smooth continuation of the EFSF, as shown in Figure 2, but it nevertheless differs in some important aspects from its predecessor. First, the EFSF was a private company operating under Luxembourg law, while the ESM is

an international organization based on international law, a multilateral lending institution. The ESM is indeed based on a treaty that is not part of the EU law (Treaty Establishing the European Stability Mechanism [TEESM]). However, when European leaders came to the conclusion in early 2011 that such a permanent institution should be established, some of them worried about its legality. Especially Germany was concerned that its Constitutional Court may strike down the TEESM, on the basis of the Art. 125 of TFEU, the so-called 'no bailout clause'.<sup>197</sup>

In order to safeguard against future judgments of its Constitutional Court, Germany pushed for the amendment of the TFEU. An extra paragraph Art. 136 (3) of the TFEU was added, using a 'simplified revision procedures' (art. 48(6) TFEU).<sup>198</sup> This amendment gave a flexibility for the Euro Area governments in drafting the TEESM, in addition to firmly grounding it in the EU law. There was a fierce debate among lawyers, and policy-makers, if the EFSF and the ESM are legal and are thus not in the contradiction with Art. 125. The logic behind the 'no bail out' clause is that it should prevent member states from borrowing and spending too much, with the expectation that in the case of difficulties they could be bailed out by another member states. One camp of lawyers, the literalists, was composed of proponents of a strict and literal reading of Art. 125. In their view legal mechanisms, such as the EFSF and the ESM, were breaching Art. 125 and were therefore illegal. The second camp, the teleologists, was in favor of reading Art. 125 in light of Art. 122 (2),

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<sup>197</sup> 'The Union shall not be liable for or assume the commitments of central governments, regional, local or other public authorities, other bodies governed by public law, or public undertakings of any Member State, without prejudice to mutual financial guarantees for the joint execution of a specific project. A Member State shall not be liable for or assume the commitments of central governments, regional, local or other public authorities, other bodies governed by public law, or public undertakings of another Member State, without prejudice to mutual financial guarantees for the joint execution of a specific project.'

<sup>198</sup> 'The Member States whose currency is the euro may establish a stability mechanism to be activated if indispensable to safeguard the stability of the euro area as a whole. The granting of any required financial assistance under the mechanism will be made subject to strict conditionality.'

which highlights a need for solidarity between the member states. In addition they stressed the telos of the EMU legal architecture, which has to be understood in a wider, and not just literal context (Tuori 2013).

In the Pringle case of 27 November 2012, the European Court of Justice (ECJ) decided, not surprisingly, that the creation of the ESM does not breach EU law. In its judgments it stated that two main conditions have to be fulfilled, before the assistance from the ESM can be provided, and thus this financial assistance is in line with the TFEU<sup>199</sup>. First, in the paragraph 137 the Court stated the condition of strict conditionality:

*However, Article 125 TFEU does not prohibit the granting of financial assistance by one or more Member States to a Member State which remains responsible for its commitments to its creditors provided that the conditions attached to such assistance are such as to prompt that Member State to implement a sound budgetary policy.*

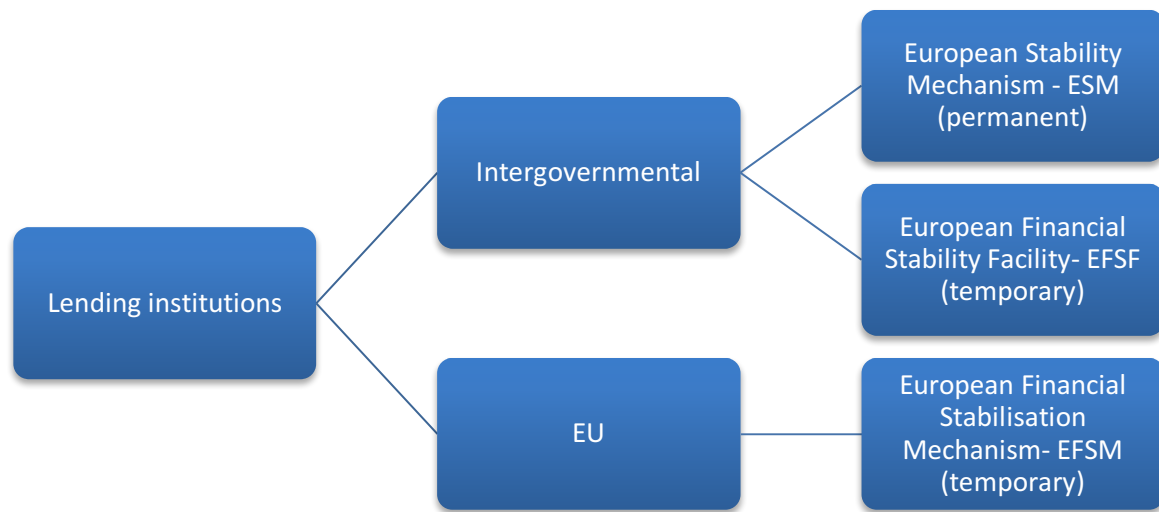
The second condition is that a member state cannot assume the debts of another member state. Financial assistance is limited to granting loans that will have to be paid back and the liability for debt or the creditors will remain unchanged. In Paragraph 138, the Court highlighted such a condition:

*As regards to the ESM Treaty, it is clear that the instruments for stability support of which the ESM may make use under Articles 14 to 18 of the ESM Treaty demonstrate that the ESM will not act as a guarantor of the debts of the recipient Member State. The latter will remain responsible to its creditors for its financial commitments.*

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<sup>199</sup> Judgment of 27 November 2012, Case C-370/12, mainly paragraph 137 and 138.

**Figure 2. European lending mechanisms**



Source: own Illustration.

In conclusion, the TEESM has been found by the Court as fulfilling both aforementioned conditions and therefore - as legal. Hence, the ECJ came to the same conclusion as the German Constitutional Court did few months earlier. Namely, in its judgment of 12 September 2012, the German Constitutional Court ruled that the TEESM is legal (here that means - in accordance with the Basic Law, the German Constitution) and therefore Germany can take part in it. However, as one could foresee, it used a different kind of argumentation than the one used by the ECJ. The German Court attached two principles to its decision. First of all, that every treaty must have a limited financial liability - Germany cannot sign a treaty that could lead to unpredictable financial liability. Secondly, any increase in its liability must be approved by the German parliament, the Bundestag.

The governing structure of the ESM, according to the TEESM, reflects a level of contributions that each state provides and consequently gives a veto power to three largest states (Germany, France and Italy). This structure also gives these states a power to overcome a veto of states whose combined vote cast do not exceed 15 % in the Board of Directors. In this way, the unanimity principle, or the federalist deficit as identified by Trechsel (2005) has been curtailed. At the same time the largest states ensured that their interests will be secured and thus created a system in which some states are more equal than others.

Whereas the ESM can be regarded as an evidence of quasi-fiscalization, the option for a full-fledged fiscalization had not been ruled out from the options of the future development of the EU, as this is one of the main ideas that were debated by the member states in the process of drafting a strategic document outlining the options for the future of the EU, a topic I turn to in the following section.

### **5.3 The debate on the Five Presidents' Report: the main arguments in favor of and against fiscalization of the EU**

The Euro crisis demonstrated the flaws of the institutional structure of the EU and consequently triggered a debate on how to address those flaws. The EU institutions - the Commission, the Council, the Eurogroup, the ECB and the Parliament - took the lead in this effort and the so-called Five Presidents' Report titled 'Completing Europe's Economic and Monetary Union' is the example thereof. In this document the presidents of these five EU institutions (Jean-Claude Juncker 'in close cooperation with' Donald Tusk, Jeroen Dijsselbloem, Mario Draghi and Martin Schultz) outlined their ideas for the future governance of the EMU. It is a crucial document, because around the ideas developed there the discussion on the future of the EU will evolve. It is the latest example of the series of other EU strategic documents that started to be produced in order to develop the framework of governance that would address the weaknesses of the governance of the EU that the crisis revealed. Those include 2012 documents produced by the Commission (2012) and the Council (2012), as well as the Four Presidents' Report (at that time the President of the Parliament was not invited).

The Five Presidents' Report is a crucial source also because there is an access to the documents presented by the member states, in which they answered a number of questions regarding their preferences on a number of topics, including the fiscal capacity (or fiscalization, as I call it in this dissertation). Admittedly, these docu-



ments are not the perfect sources, but they nonetheless have a number of advantages, which makes them suitable for this type of study, as explained in Chapter 3.3. The publication of the Report was preceded by a discussion among the member states, which were asked to present their contributions regarding the future of the EMU. This discussion started on 12 February 2015 with an analytical note prepared by Jean-Claude Juncker, the President of the Commission, in cooperation with three other Presidents (the President of the Parliament, Martin Schulz joined only later).

This note summarized the economic situation in the EMU and finished with eleven issues/questions, which served as a basis for the future discussion. Three questions (numbered 3, 8 and 9) can be regarded as concerning a fiscal capacity<sup>200</sup> (even if neither this term, nor 'fiscal union' is mentioned explicitly), with the last one being the most specific: 'Is a further risk-sharing in the fiscal realm desirable? What would be the preconditions?' However, the member states were not bound by those questions and could raise any issue they deemed important for the better governance of the EMU. For instance, Italy clearly stated at the beginning of its first contribution that the note does not cover all the topics, which are vital for the future of the EMU. In total, we have access to 44 contributions from the member states and the European Parliament (some countries provided two documents). Only Greece did not provide any written contribution.

Subsequently, in a document from April 2015, the Sherpas - i.e. the officials who represent heads of states or governments and prepare the summits - were asked seven questions and the third one regarded fiscal capacity. Within the general question about a fiscal capacity, the member states were asked three specific questions on 'how', 'why' and 'when': first, if the fiscal capacity should be linked to structural

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<sup>200</sup> '3) Is the current governance framework – if fully implemented – sufficient to make the euro area shock-resilient and prosperous in the long run? (...) 8) To what extent is the present sharing of sovereignty adequate to meet the economic, financial and fiscal framework requirements of the common currency? (...) 9) Is a further risk-sharing in the fiscal realm desirable? What would be the preconditions?'

reforms ('how?'). Second, what kind of purpose should prospective fiscal capacity serve ('why?'). Third, 'when' such a solution should be implemented.<sup>201</sup> The creation of fiscal capacity at the EU level was one of the main issues in this debate and a vast majority of the member states provided their clear opinion. Still, some of the most important countries, like France and Germany, avoided providing their clear stance on fiscal union in their written contribution.<sup>202</sup> One of the possible reasons for that may be the fact that those two countries work on a compromise, as they pledged to provide their common position until the end of 2016.<sup>203</sup>

In a note for the discussion by the Sherpas on the 'better economic governance in the Euro Area' from 21 April 2015 it was stated that in several contributions 'the need for a prospective fiscal capacity for the Euro Area' was raised. Moreover, it noticed that all mature monetary unions include some sort of fiscal capacity and that progress towards this end will have to be gradual and could be based on own resources. Further, two purposes for which such a fiscal capacity could serve was outlined. First, it could be used as a European investment tool. Second, some contributions proposed that such a fiscal capacity could accommodate asymmetric economic shocks, for instance through the creation of an unemployment insurance scheme.

The note highlighted the fact that some contributions raised the issue that 'such a fiscal capacity should be based on strong preconditions and conditionality', such as even stricter coordination of national fiscal policies. What is more, some countries proposed the mutualization of the sovereign debt. This also would be based on a

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<sup>201</sup> 'Regarding a prospective fiscal capacity for the Euro Area, should it be linked to progress on structural reforms, and if so in what form? What other functions should such a fiscal capacity serve (e.g. investment, asymmetric shock absorption)? How could it be phased in?' Report on Preparing for Next Steps on Better Economic Governance in the Euro Area Questions for Sherpas ahead of the meeting on 27 April 2015, [http://ec.europa.eu/priorities/sites/beta-political/files/issues\\_for\\_discussion\\_by\\_the\\_sherpas\\_en.pdf](http://ec.europa.eu/priorities/sites/beta-political/files/issues_for_discussion_by_the_sherpas_en.pdf) (accessed: 2 March 2017)

<sup>202</sup> Indeed, a 'warning' above all contributions states: 'Not all Sherpas submitted written contributions and some preferred to keep them confidential.'

<sup>203</sup> At the time of writing - November 2017 - such a contribution has not been delivered.

condition of stricter budgetary coordination and would need avoid moral hazard. Interestingly, this idea was presented not as complementary of fiscal capacity (in theory, funds needed for such mutualization could be obtained from this very capacity), but as an alternative to fiscal union.<sup>204</sup>

In a note that followed a month later, a draft was presented with an outline of the issues that were discussed by the Sherpas, which should be included in the final report. Here again, the objectives of such capacity were summarized. This time, instead of ‘an investment tool’, the accent was put on the common (i.e. European) public goods, which would be a consequence of such an investment mechanism. The second objective was, as in the previous notes, ‘a shock absorption function’ for the Euro Area. Again, the emphasis was placed on the conditional access to the future ‘shock absorption mechanism’, which would be based on the compliance with economic policy guidelines (‘sufficient progress towards the commonly agreed benchmarks for key structural policies’). The previous solutions are appropriate in the medium term, while in the longer term, this document envisioned a need of a paradigm shift at the EU level - a shift from the regulation of fiscal policies to fiscalization of the EU, to use concepts incorporated in this dissertation, or ‘from a sys-

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<sup>204</sup> ‘(...) the need for a prospective fiscal capacity for the Euro Area is raised in several contributions. The history and experience of other currency unions show that there are various ways to progress towards a fiscal union. There is no set template. Yet, while the degree of commonality of budgetary instruments and arrangements differ, all mature currency unions are endowed with some sort of common fiscal capacity. This may take several forms and would need to be a gradual process. Such a capacity could be endowed with its own resources (e.g. building on work by the Monti High Level Group). According to this view, such capacity could take the form of an investment tool at the European level (e.g. building on the European Fund for Strategic Investment). Some consider also that it should be shaped in a way to address significant asymmetric shocks (e.g. through a complementary unemployment insurance scheme). However, some contributions also acknowledge that such a fiscal capacity should be based on strong preconditions and conditionality, including a closer coordination of the national budgets at the Euro Area level. Finally, as an alternative to the fiscal capacity, some contributions also mention a need for sovereign debt mutualisation. According to this view, this should be done in a way that minimises moral hazard and is commensurate with additional pooling of sovereignty as regards budgetary policy.’, Note for discussion by Sherpas Preparing for Next Steps on Better Economic Governance in the Euro Area: Overview of contributions by Member States and the European Parliament, 21 April 2015, available at [http://ec.europa.eu/priorities/sites/beta-political/files/note\\_for\\_discussion\\_by\\_sherpas\\_-\\_overview\\_en.pdf](http://ec.europa.eu/priorities/sites/beta-political/files/note_for_discussion_by_sherpas_-_overview_en.pdf) accessed 3 March 2017.

tem of rules and guidelines for economic and fiscal policies towards a system of commensurate sovereignty sharing within common institutions'.<sup>205</sup>

Furthermore, the progress towards such fiscal solutions at the EU level, would need to be complemented with a 'stronger democratic participation and accountability'.<sup>206</sup> As one can see, there is a considerable attention and knowledge among the member states about an idea of a fiscal union, which would complete the currency union. A majority of the member states, as summarized in Table 7 below, either favored or were willing to consider fiscalization of the Euro Area. Moreover, some common goals, like public goods or shock absorption mechanism, were frequently identified as the objectives such a fiscal union could serve.

In total, 26 member states provided their contributions (all but Greece and Croatia, which joined the EU only afterwards). As the Table 7 shows, there are nine member states that are clearly in favor of fiscalization. One third of this group are the non-Euro Area members (Poland, the UK and Bulgaria), and the rest is equally divided between the Southern debtor states: Spain, Portugal and Italy and small Northern creditor states: Luxembourg, Austria and Belgium.

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<sup>205</sup> 'In the medium- to longer run, some public goods could be provided commonly and a shock absorption function would be set up at the euro area level. Access to this would be made conditional on sufficient progress towards the commonly agreed benchmarks for key structural policies. At the same time, as the euro area evolves towards a genuine economic and fiscal union, there would be a need for moving from a system of rules and guidelines for economic and fiscal policies towards a system of commensurate sovereignty sharing within common institutions. This shift would need to be accompanied with stronger democratic participation and accountability both at national and European levels.' Note for discussion by Sherpas Next Steps on Better Economic Governance in the Euro Area Draft Outline, 22 May 2015, available at [http://ec.europa.eu/priorities/publications/note-discussion-sherpas-draft-outline-report\\_en](http://ec.europa.eu/priorities/publications/note-discussion-sherpas-draft-outline-report_en) (accessed 3 March 2017).

<sup>206</sup> 'This shift would need to be accompanied with stronger democratic participation and accountability both at national and European levels.' Note for discussion by Sherpas Next Steps on Better Economic Governance in the Euro Area Draft Outline, 22 May 2015, available at [http://ec.europa.eu/priorities/publications/note-discussion-sherpas-draft-outline-report\\_en](http://ec.europa.eu/priorities/publications/note-discussion-sherpas-draft-outline-report_en) (accessed 3 March 2017).

**Table 7. The positions of the member states on the fiscalization of the EU**

<b>Position</b>	<b>Member state</b>
<b>In favor of fiscalization in the medium to the long term</b>	Spain <sup>207</sup>
<b>In favor of fiscalization in the long term</b>	Italy, Austria, Belgium, Bulgaria, Poland, the UK, Luxembourg, Portugal
<b>Skeptical of fiscalization, but willing to consider it</b>	Cyprus, the Czech Republic, Denmark, Estonia, Hungary, Ireland, Lithuania, Latvia, Slovenia, Slovakia, Romania
<b>Against fiscalization</b>	Finland, Netherlands <sup>208</sup> , Malta <sup>209</sup>
<b>Fiscalization not mentioned</b>	Sweden, Germany, France <sup>210</sup>

Source: own illustration.

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<sup>207</sup> 'In our view, a fully-fledged fiscal union should encompass a budgetary risk-sharing arrangement, joint decision making for a European orientation of fiscal policy and a certain level of risk pooling in debt issuance. These proposals are still valid and need to be approached in the medium to long term', Contributions from the Sherpas of the Member States to the Five Presidents' Report: Spain, First Contribution [no date]: 1, available at [https://ec.europa.eu/priorities/sites/beta-political/files/spain\\_contribution\\_1\\_en.pdf](https://ec.europa.eu/priorities/sites/beta-political/files/spain_contribution_1_en.pdf) (accessed 17 February 2017).

<sup>208</sup> 'Addressing questions in the realm of further risk sharing, new competences or institutions in the Four Presidents' Report is premature.', Contributions from the Sherpas of the Member States to the Five Presidents' Report: Netherlands, First Contribution, March 2015: 3, available at [https://ec.europa.eu/commission/priorities/sites/beta-political/files/netherlands\\_contribution\\_1\\_en.pdf](https://ec.europa.eu/commission/priorities/sites/beta-political/files/netherlands_contribution_1_en.pdf) accessed 17 February 2017).

<sup>209</sup> 'We are open to explore further possibilities in the future as long as it is not a fully fledged fiscal union. In the shorter term then, we believe that we should fully utilise all the work that has been carried out.', Contributions from the Sherpas of the Member States to the Five Presidents' Report: Malta, First Contribution, 13 March 2015: 3, available at [https://ec.europa.eu/priorities/sites/beta-political/files/malta\\_contribution\\_1\\_en.pdf](https://ec.europa.eu/priorities/sites/beta-political/files/malta_contribution_1_en.pdf) (accessed 11 March 2016).

<sup>210</sup> Those two countries promised to deliver their position on the prospect of fiscal capacity of the Euro Area by the end of 2016.

Interestingly, the largest number of the member states is in the group 'Skeptical of fiscalization, but willing to consider it'. Within this group, there are no major creditor states - it consists of eleven member states in total: all the Baltic states, the Visegrad countries, but Poland, the two other eastern member states - Slovenia and Romania, in addition to Denmark, a non-Euro Area country. Remarkably, two debtor countries, which were bailed-out during the crisis - Ireland and Cyprus, were also in this group of the skeptics of the idea of fiscalization. The third group consists of the member states, which were against fiscalization, Finland and Netherlands, the two major creditor countries in addition to Malta.

I will now turn into a more detailed analysis of this debate, focusing on the arguments related to fiscalization of the EU. I aim to find out if the arguments mentioned the main factor underpinning my hypothesis - a threat. I divided the arguments presented by the EU member states into three categories: the preconditions for fiscalization, positive consequences of fiscalization and the negative consequences thereof.

### ***5.3.1 The preconditions for fiscalization of the EU***

The member states (or, to be more precise, the Sherpas who took the positions on behalf of their countries) that were either clearly in favor or willing to consider fiscalization of the Euro Area attached several preconditions to such a solution. I outline these preconditions below.

#### **i.) a better national budget surveillance enforcement**

The Czech Republic and Latvia viewed a better coordination of the national fiscal policies as a precondition for the fiscal capacity. Moreover, the Czech Republic stated that it may give its consent to a fiscal capacity, but first there should be a 'better enforcement of responsible behavior of national authorities', especially in the fiscal domain,<sup>211</sup> which should first gain 'proper credibility or demonstrates itself to be ineffective.' Only afterwards 'a common fiscal capacity for the Eurozone' can be envisaged.<sup>212</sup> Latvia also proposed a fiscal capacity 'with strong preconditions and

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<sup>211</sup> 'To ensure that sharing of fiscal risks does not lead to a substantial moral hazard of countries because of their fiscally or in other way irresponsible behavior, it should be enabled only if there is a better enforcement of responsible behavior of national authorities. 'Contributions from the Sherpas of the Member States to the Five Presidents' Report: Czech Republic, First Contribution: 3, available at [http://ec.europa.eu/priorities/sites/beta-political/files/czech\\_contribution\\_1\\_en.pdf](http://ec.europa.eu/priorities/sites/beta-political/files/czech_contribution_1_en.pdf) (accessed 17 February 2017).

<sup>212</sup> 'A common fiscal capacity for the eurozone can be executively considered after the current coordination mechanism obtains proper credibility or demonstrates itself to be ineffective.' Contributions from the Sherpas of the Member States to the Five Presidents' Report: Czech Republic, Second Contribution, 15 May 2015: 3, available at [http://ec.europa.eu/priorities/sites/beta-political/files/czech\\_contribution\\_2\\_en.pdf](http://ec.europa.eu/priorities/sites/beta-political/files/czech_contribution_2_en.pdf) (accessed 17 February 2017).

conditionality, including a closer coordination of the national budgets at the EU level'.<sup>213</sup>

Lithuania, on the other hand, gave a somehow vague answer to the question if a further risk sharing in the fiscal realm is desirable - it highlighted the fact that the existing rules should be respected in a first place. Only after some time further action could be considered, but those actions would focus on closing the 'loopholes of the fiscal framework'.<sup>214</sup> By the same token, Luxembourg linked a fiscal capacity to not only the willingness of the member states to 'further yield sovereignty to the European level', but most of all - 'reinforcement of the fiscal surveillance framework'.<sup>215</sup>

Similarly, the Portuguese proposal of creating a European Monetary Fund with its own fiscal capacity, contained a caveat that such a solution will not undermine the fiscal discipline and will not lead to permanent transfers between countries.<sup>216</sup> Slovakia, then, pointed out that creating a fiscal capacity, which would be linked to

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<sup>213</sup> 'An EU level fiscal capacity (with strong preconditions and conditionality, including a closer coordination of the national budgets at the EU level) could help Member States facilitate implementation of structural reforms that are necessary and significant for enhancing Member States' competitiveness.', Contributions from the Sherpas of the Member States to the Five Presidents' Report: Latvia, Second Contribution: 1, available at [http://ec.europa.eu/priorities/sites/beta-political/files/latvia\\_contribution\\_2\\_en.pdf](http://ec.europa.eu/priorities/sites/beta-political/files/latvia_contribution_2_en.pdf) (accessed 17 February 2017).

<sup>214</sup> 'Is a further sharing in the fiscal realm desirable? What would be the preconditions? - First of all, we should ensure implementation of existing rules/legal acts and after some time it would be seen the loopholes of the fiscal framework and needed actions.', Contributions from the Sherpas of the Member States to the Five Presidents' Report: Lithuania [no date]: 3, available at [https://ec.europa.eu/priorities/sites/beta-political/files/lithuania\\_contribution\\_1\\_en.pdf](https://ec.europa.eu/priorities/sites/beta-political/files/lithuania_contribution_1_en.pdf) (accessed 17 February 2017).

<sup>215</sup> 'Pre-conditions for such considerations are the willingness of Member States and national parliaments to further yield sovereignty to the European level, and the reinforcement of the fiscal surveillance framework.' Contributions from the Sherpas of the Member States to the Five Presidents' Report: Luxembourg [no date]: 7, available at [https://ec.europa.eu/priorities/sites/beta-political/files/luxembourg\\_contribution\\_1\\_en.pdf](https://ec.europa.eu/priorities/sites/beta-political/files/luxembourg_contribution_1_en.pdf) (accessed 11 March 2016).

<sup>216</sup> 'A fundamental element of this reformed architecture of the euro is a European Monetary Fund (EMF). An institution such as the EMF would not comprise univocal and permanent transfers between countries, nor would remove the need for fiscal discipline at national level. It would be an instrument of common responsibility, greater credibility and economic soundness.', Contributions from the Sherpas of the Member States to the Five Presidents' Report: Portugal, Second Contribution [no date]: 5-6, available at [https://ec.europa.eu/priorities/sites/beta-political/files/portugal\\_contribution\\_2\\_en.pdf](https://ec.europa.eu/priorities/sites/beta-political/files/portugal_contribution_2_en.pdf) (accessed 17 February 2017).



compliance with the fiscal rules, could in fact solve both problems of the EMU - its incompleteness in the fiscal realm, as well as the lack of compliance with its fiscal rules.<sup>217</sup> Likewise, Slovenia noted that a room of policy manoeuvre for the member states is very limited since 'a lack of independent monetary policy, constrained fiscal policy'. Against this backdrop, Slovenia was willing to consider the fiscal capacity, as long as the fiscal rules will be fully enforced first.<sup>218</sup> Romania, on the other hand, acknowledged that in the long term there may be a need for the 'shock-resilience of the Euro area', but in the short and medium term Romania favored a 'full implementation' of the of the already consolidated mechanisms within the governance framework.<sup>219</sup>

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<sup>217</sup> 'We believe that such new instruments should also be linked to compliance with the existing fiscal rules by EU Member States. In this way, an important gap in the architecture of the EMU as well as a long standing problem of insufficient compliance with the SGP could be addressed.', Contributions from the Sherpas of the Member States to the Five Presidents' Report: Slovakia, First Contribution [no date]: 2-3, [https://ec.europa.eu/priorities/sites/beta-political/files/slovakia\\_contribution\\_1\\_en.pdf](https://ec.europa.eu/priorities/sites/beta-political/files/slovakia_contribution_1_en.pdf) (accessed 17 February 2017), see also: 'While some Member States may want to support the initiative for fiscal capacity for the Euro Area, in other countries opposition towards the deepening of the EMU is to be expected. An acceptable compromise may take the form of linking the participation in the fiscal instruments proposed with the observance of the common fiscal rules. From the point of view of Slovakia, fiscal and economic discipline, including equal and transparent application of SGP and MIP, is a necessary condition for the further deepening of fiscal integration. Consequently, adherence to existing rules, applied in a transparent and equal manner to all Member States, could be a criterion for entry into a fiscal union.', Contributions from the Sherpas of the Member States to the Five Presidents' Report: Slovakia, Second Contribution [no date]: 2, [https://ec.europa.eu/priorities/sites/beta-political/files/slovakia\\_contribution\\_2\\_en.pdf](https://ec.europa.eu/priorities/sites/beta-political/files/slovakia_contribution_2_en.pdf) (accessed 17 February 2017).

<sup>218</sup> 'Currently a room for independent policy action of Member States is very limited, since Member States are faced with a lack of independent monetary policy, constrained fiscal policy and banking union. Further risk sharing would only be possible if the existing budget and economic policy monitoring and surveillance framework is vigorously enforced and implemented. Furthermore, it should be additionally strengthened to encourage sound fiscal positions and prevent moral hazard and the danger of lax implementation of reforms, which could arise as a consequence of existence of common risk sharing instruments. If the abovementioned conditions are met, options on potential risk sharing could be examined.', Contributions from the Sherpas of the Member States to the Five Presidents' Report: Slovenia, 27 March 2015: 5, available at [https://ec.europa.eu/priorities/sites/beta-political/files/slovenia\\_contribution\\_1\\_en.pdf](https://ec.europa.eu/priorities/sites/beta-political/files/slovenia_contribution_1_en.pdf) (accessed 17 February 2017).

<sup>219</sup> 'Therefore, while acknowledging that important challenges remain with respect to the shock-resilience of the Euro area, we deem more efficient, at least on a short and medium term, to focus on the full implementation, both at EU and national level of the already consolidated mechanisms within the governance framework.' Contributions from the Sherpas of the Member States to the Five Presidents' Report: Romania, available at <https://ec.europa.eu/commission/sites/beta->

## ii.) sound fiscal policies

For Italy, the new economic governance of the EU already provided many preconditions for a fiscal union, such as ‘credibility and trustworthiness of national fiscal policies’, which have been ‘strengthened’.<sup>220</sup> Other countries were not that optimistic, and highlighted the fact that many regulations that are already in place, should be fully implemented before further fiscal integration takes off. Poland, for instance, supported a fiscal capacity in the long term, under the condition that sound fiscal policies would be maintained at the member state level, and so the fiscal rules of the SGP will be respected. Moreover, it highlighted the fact that the no bailout clause will need to be ‘restored’, before the fiscal union will be established.<sup>221</sup> Poland was against the introduction of the new institutions at this point of integration<sup>222</sup>, by which it meant before 2019.<sup>223</sup> However, it supported such solution in the long term,

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political/files/romania\_contribution\_1\_en.pdf (accessed 17 February 2017).

<sup>220</sup> ‘The development of such a function requires further transfers of sovereignty, drawing nearer a true Political union as envisaged in the 2012 Four Presidents’ Report. Since then, fiscal surveillance for euro area member countries has significantly shifted towards a more centralized approach: a stronger control on national budgets of the Euro area is now in place with the possibility of requesting changes in draft budgetary plans. In addition, credibility and trustworthiness of national fiscal policies has been strengthened with the approval in all national legislations of provisions of the Fiscal compact, including automatic corrective mechanisms and the establishment of independent fiscal councils. Against this backdrop, many of the preconditions for the implementation of common stabilization mechanisms are already in place.’, Contributions from the Sherpas of the Member States to the Five Presidents’ Report: Italy, Second Contribution: 7, [http://ec.europa.eu/priorities/sites/beta-political/files/italy\\_contribution\\_2\\_en.pdf](http://ec.europa.eu/priorities/sites/beta-political/files/italy_contribution_2_en.pdf) (accessed 17 February 2017).

<sup>221</sup> ‘In the long run such an action [to ‘further Europeanise fiscal policy’] would be desirable provided that the Eurozone preserves the predominant role of the market mechanisms in disciplining the MSs to pursue prudent fiscal policies, the credibility of the no bailout clause is restored, the credibility of the rules at the level of particular Member States is maintained (...)’, Contributions from the Sherpas of the Member States to the Five Presidents’ Report: Poland, First Contribution, [no date]:5, available at [https://ec.europa.eu/commission/sites/beta-political/files/poland\\_contribution\\_1\\_en.pdf](https://ec.europa.eu/commission/sites/beta-political/files/poland_contribution_1_en.pdf) (accessed 17 February 2017).

<sup>222</sup> ‘In Poland’s view, the establishment of new institutions is not required at the current stage of the EMU integration.’, Contributions from the Sherpas of the Member States to the Five Presidents’ Report: Poland, First Contribution, [no date]: available at [https://ec.europa.eu/commission/sites/beta-political/files/poland\\_contribution\\_1\\_en.pdf](https://ec.europa.eu/commission/sites/beta-political/files/poland_contribution_1_en.pdf) (accessed 17 February 2017).

<sup>223</sup> ‘In Poland’s view it is not necessary to further Europeanise fiscal policy ahead of 2019.’

under several preconditions, such as maintaining 'prudent fiscal policies' of the member states.<sup>224</sup>

Comparably, for the Spanish to ensure sound fiscal policies was a precondition of the fiscal union, but they put more accent on the need of the latter solution ('European orientation of fiscal policy'), writing that 'the EMU needs to be capable of providing a coordinated fiscal policy stimulus in times of economic crisis'.<sup>225</sup> Spain wanted fiscal coordination ('a continuous and dynamic monitoring and correction mechanism') that will not only be a precondition of the next stages of fiscal integration, but will serve as a permanent benchmark, which would exist also after such a fiscal union is established.<sup>226</sup>

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<sup>224</sup> 'In the long run such an action (i.e. of 'further Europeanise fiscal policy') would be desirable provided that the Eurozone preserves the predominant role of the market mechanisms in disciplining the MSs to pursue prudent fiscal policies, the credibility of the no bailout clause is restored, the credibility of the rules at the level of particular Member States is maintained, the level of political integration is increased and some competences in the area of economic and fiscal policy are transferred to the European level. In the long term, the fiscal integration would also increase the effectiveness of adjustment mechanisms to asymmetric shocks in the Eurozone. However it would require an appropriate deepening of political integration.', Contributions from the Sherpas of the Member States to the Five Presidents' Report: Poland, First Contribution, [no date]: available at [https://ec.europa.eu/commission/sites/beta-political/files/poland\\_contribution\\_1\\_en.pdf](https://ec.europa.eu/commission/sites/beta-political/files/poland_contribution_1_en.pdf) (accessed 17 February 2017).

<sup>225</sup> 'The framework for fiscal discipline enshrined in the SGP needs to be complemented by mechanisms allowing for a European orientation of fiscal policy. While maintaining sound budgetary positions in the medium and long term, the EMU needs to be capable of providing a coordinated fiscal policy stimulus in times of economic crisis or output growth below its potential.', Contributions from the Sherpas of the Member States to the Five Presidents' Report: Spain, First Contribution [no date]: 4, available at [http://ec.europa.eu/priorities/sites/beta-political/files/spain\\_contribution\\_1\\_en.pdf](http://ec.europa.eu/priorities/sites/beta-political/files/spain_contribution_1_en.pdf) (accessed 17 February 2017).

<sup>226</sup> 'Third: agree on a precise roadmap to achieve a full fiscal union. This roadmap needs to be simple and predictable, while incorporating adequate incentives and strict conditions to ensure the stability of the Union. The process should be based on the strengthened policy coordination process and its set of indicators, which will function as a continuous and dynamic monitoring and correction mechanism. That is, not only accessing further phases of fiscal integration will be conditional on the fulfillment of established thresholds for fiscal and external sector indicators, but these thresholds will also be considered permanent requirements. By enshrining the convergence process in a stable policy coordination framework, the EMU guarantees that adequate monitoring will continue once the Fiscal Union is in place, triggering correction mechanisms if necessary.', Contributions from the Sherpas of the Member States to the Five Presidents' Report: Spain, First Contribution [no date], available at [http://ec.europa.eu/priorities/sites/beta-political/files/spain\\_contribution\\_1\\_en.pdf](http://ec.europa.eu/priorities/sites/beta-political/files/spain_contribution_1_en.pdf) (accessed 17 February 2017).

### iii.) a link to structural reforms

Latvia was of the view that the access to the future fiscal capacity ‘should be linked to progress on structural reforms’<sup>227</sup> and this would ‘facilitate implementation of structural reforms that are necessary and significant for enhancing Member States’ competitiveness’.<sup>228</sup> Likewise, Spain expressed an idea that the access to the resources of the future fiscal union should be linked with the ‘newly defined convergence criteria’, which would promote ‘fiscal and external balanced positions’.<sup>229</sup> Ireland, on the other hand, was more vague and stated that: ‘(a)ny form of risk mutualization would require strong conditionality.’<sup>230</sup> Portugal also supported the idea that conditionality should be applied to countries seeking financial assistance from the reformed ESM.<sup>231</sup>

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<sup>227</sup> ‘Yes, fiscal capacity for the Euro Area should be linked to progress on structural reforms.’, Contributions from the Sherpas of the Member States to the Five Presidents’ Report: Latvia, Second Contribution: 2, available at [https://ec.europa.eu/commission/sites/beta-political/files/latvia\\_contribution\\_2\\_en.pdf](https://ec.europa.eu/commission/sites/beta-political/files/latvia_contribution_2_en.pdf) (accessed 17 February 2017).

<sup>228</sup> ‘An EU level fiscal capacity (with strong preconditions and conditionality, including a closer coordination of the national budgets at the EU level) could help Member States facilitate implementation of structural reforms that are necessary and significant for enhancing Member States’ competitiveness.’, Contributions from the Sherpas of the Member States to the Five Presidents’ Report: Latvia, Second Contribution: 1, available at [https://ec.europa.eu/commission/sites/beta-political/files/latvia\\_contribution\\_2\\_en.pdf](https://ec.europa.eu/commission/sites/beta-political/files/latvia_contribution_2_en.pdf) (accessed 17 February 2017).

<sup>229</sup> Contributions from the Sherpas of the Member States to the Five Presidents’ Report: Spain, Second Contribution, 14 May 2015: 4, available at [https://ec.europa.eu/priorities/sites/beta-political/files/spain\\_contribution\\_2\\_en.pdf](https://ec.europa.eu/priorities/sites/beta-political/files/spain_contribution_2_en.pdf) (accessed 17 February 2017).

<sup>230</sup> Contributions from the Sherpas of the Member States to the Five Presidents’ Report: Ireland, First Contribution [no date]: 5, available at [http://ec.europa.eu/priorities/sites/beta-political/files/czech\\_contribution\\_2\\_en.pdf](http://ec.europa.eu/priorities/sites/beta-political/files/czech_contribution_2_en.pdf) (accessed 17 February 2017).

<sup>231</sup> ‘The Eurogroup would of course play a political monitoring role and full conditionality to lending would apply but political arguments between creditors and debtors and fractures along national lines should be prevented in the future.’, Contributions from the Sherpas of the Member States to the Five Presidents’ Report: Portugal, First Contribution [no date]: 3, available at [https://ec.europa.eu/priorities/sites/beta-political/files/portugal\\_contribution\\_1\\_en.pdf](https://ec.europa.eu/priorities/sites/beta-political/files/portugal_contribution_1_en.pdf) (accessed 17 February 2017).

#### **iv.) respecting integrity of the single market and the rights of non-Euro Area member states**

The Czech Republic insisted that the integrity of the EU should be protected. Importantly, the establishment of further institutions for the Euro Area could undermine it and as a consequence 'further separate the euro area from the rest of the EU.'<sup>232</sup> Moreover, if in the Euro Area a fiscal capacity will be established, 'a level playing field for the pre-in member states' should be guaranteed.'<sup>233</sup> Similarly, Hungary highlighted the fact that creating a fiscal union among Euro Area countries will further accelerate differentiation with the non-Euro Area members, in addition of a call that any such fiscal union should aim to 'to maintain the integrity of the single market'.<sup>234</sup> Likewise, Poland stressed that the Five Presidents' Report should focus on a short and medium term. However, it was open for a discussion on solutions needed in a long term (after 2019), but any further 'institutional chang-

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<sup>232</sup> 'If there is no further integration towards a federative structure of the EU, the rules should play a greater role. The CZ does not support creating any additional institutions which would further separate the euro area from the rest of the EU.', Contributions from the Sherpas of the Member States to the Five Presidents' Report: Czech Republic, First Contribution: 2, available at [http://ec.europa.eu/priorities/sites/beta-political/files/czech\\_contribution\\_1\\_en.pdf](http://ec.europa.eu/priorities/sites/beta-political/files/czech_contribution_1_en.pdf) (accessed 17 February 2017).

<sup>233</sup> 'if fiscal capacity is to be considered in the Report, it should ensure a level playing field for the pre-in member states.' Contributions from the Sherpas of the Member States to the Five Presidents' Report: Czech Republic, Second Contribution, 15 May 2015: 3, available at [http://ec.europa.eu/priorities/sites/beta-political/files/czech\\_contribution\\_2\\_en.pdf](http://ec.europa.eu/priorities/sites/beta-political/files/czech_contribution_2_en.pdf) (accessed 17 February 2017).

<sup>234</sup> 'Deepening of economic policy coordination and steps towards fiscal union within the euro area shall accentuate the already existing differences between the euro area and the non euro countries which should be properly dealt with. In that respect Hungary would like to call the attention to elements of commonness of EU28, in particular to the need to maintain the integrity of the single market and inclusiveness to be continued to be respected' Contributions from the Sherpas of the Member States to the Five Presidents' Report: Hungary, 27 March 2016: 2, available at [https://ec.europa.eu/priorities/sites/beta-political/files/hungary\\_contribution\\_1\\_en.pdf](https://ec.europa.eu/priorities/sites/beta-political/files/hungary_contribution_1_en.pdf) (accessed 17 February 2017); also: 'Changes to the governance of the single currency should be done in a way that fully protects the integrity of the single market, and ensures the interests of all member states, whether inside or outside the single currency, are respected', Contributions from the Sherpas of the Member States to the Five Presidents' Report: UK, Second Contribution, [no date]: 1, available at [https://ec.europa.eu/priorities/sites/beta-political/files/uk\\_contribution\\_2\\_en.pdf](https://ec.europa.eu/priorities/sites/beta-political/files/uk_contribution_2_en.pdf) (accessed 17 February 2017).

es in the Eurozone', should not distort 'the principles of the single market' and competitiveness.<sup>235</sup>

Denmark, a non-Euro Area member, wished that if the fiscal capacity ('further risk-sharing') is established, it would have to be done in a transparent way for all member states and should assure 'compatibility with the Single Market'.<sup>236</sup> Equally, the UK, which generally supported the idea for a Euro Area fiscal union, noticing that it will be a matter for the Euro Area to decide'<sup>237</sup>, but at the same time maintained that the interests of the non-participating states should be 'protected'.<sup>238</sup>

## **v.) a gradual process**

Latvia recommended making use of the existing Treaties first, before starting discussions on the Treaty change, especially in the context of the debt mutualization,

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<sup>235</sup> 'All the possible solutions related to the economic governance and to the prospective changes in the institutional framework of the Eurozone should be in accordance with: 1) the principle of the openness towards the non-Eurozone Member States and 2) the principles of the single market. Moreover they should not distort the competitiveness of the Member States and the EU as a whole.', Contributions from the Sherpas of the Member States to the Five Presidents' Report: Poland, First Contribution, [no date]: 1, available at [https://ec.europa.eu/commission/sites/beta-political/files/poland\\_contribution\\_1\\_en.pdf](https://ec.europa.eu/commission/sites/beta-political/files/poland_contribution_1_en.pdf) (accessed 17 February 2017).

<sup>236</sup> 'Should the Euro area Member States decide to move forward with initiatives on further risk-sharing, Denmark would underline the need for openness and transparency for all Member States as well as full compatibility with the Single Market.', Contributions from the Sherpas of the Member States to the Five Presidents' Report: Denmark, 26 March 2016: 4, available at [https://ec.europa.eu/priorities/sites/beta-political/files/denmark\\_contribution\\_1\\_en.pdf](https://ec.europa.eu/priorities/sites/beta-political/files/denmark_contribution_1_en.pdf) (accessed 17 February 2017).

<sup>237</sup> Contributions from the Sherpas of the Member States to the Five Presidents' Report: UK, Second Contribution, [no date]: 4, available at [https://ec.europa.eu/priorities/sites/beta-political/files/uk\\_contribution\\_2\\_en.pdf](https://ec.europa.eu/priorities/sites/beta-political/files/uk_contribution_2_en.pdf) (accessed 17 February 2017).

<sup>238</sup> 'As these new structures and institutions gradually become part of the European framework, and as the euro area considers potential further steps as part of this Four Presidents' process, an important element should be to give proper consideration to ensuring the interests of both euro area member states and non-euro area member states (including those, unlike the UK, who may wish to join the euro) are fully respected, and that the rights of all are properly protected', Contributions from the Sherpas of the Member States to the Five Presidents' Report: UK, First Contribution, [no date]: 1, available at [https://ec.europa.eu/priorities/sites/beta-political/files/uk\\_contribution\\_1\\_en.pdf](https://ec.europa.eu/priorities/sites/beta-political/files/uk_contribution_1_en.pdf) (accessed 17 February 2017).



as proposed by the Blueprint of the Commission from 2012. Such proposals should be treated with ‘extreme caution’.<sup>239</sup> Contrary, Spain envisioned the creation of a fiscal union as a gradual process with phases, each one in a different time perspective: the short, the medium and the long term. Such a fiscal union will subsequently advance to amount in its final stage (beyond 2020) to the following measures: ‘(1) transfer of sovereignty to the Union on national revenue and expenditure policies; (2) a common Eurozone budget; (3) common debt instruments’.<sup>240</sup> Similarly, Italy put emphasis on the step-by-step approach.<sup>241</sup> Such a gradualism would help to ‘overcome political obstacles and build broad consensus’, but a ‘pragmatic approach’ is needed to implement such an ambitious project.<sup>242</sup>

#### **vi.) respect for tax autonomy of the member states**

Ireland was especially vocal in opposing the idea that moral hazard, which a fiscal union may create, should be addressed by tax convergence or tax coordination, be-

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<sup>239</sup> ‘As to the possible building blocks for a longer term, a discussion could be based on the Blueprint for a Genuine Economic and Monetary Union. At the same time, some of the elements of the Blueprint (for instance, common debt instruments, debt mutualisation) must be treated with extreme caution.’, Contributions from the Sherpas of the Member States to the Five Presidents' Report: Latvia, Second Contribution: 2, available at [https://ec.europa.eu/commission/sites/beta-political/files/latvia\\_contribution\\_2\\_en.pdf](https://ec.europa.eu/commission/sites/beta-political/files/latvia_contribution_2_en.pdf) (accessed 17 February 2017)

<sup>240</sup> Contributions from the Sherpas of the Member States to the Five Presidents' Report: Spain, Second Contribution, 14 May 2015: 4, available at [https://ec.europa.eu/priorities/sites/beta-political/files/spain\\_contribution\\_2\\_en.pdf](https://ec.europa.eu/priorities/sites/beta-political/files/spain_contribution_2_en.pdf) (accessed 17 February 2017).

<sup>241</sup> ‘To build broad consensus, a gradual phasing in can be envisaged, provided that it signals a common sense of direction and unity of purpose’, Contributions from the Sherpas of the Member States to the Five Presidents' Report: Italy, first Contribution: 5, available at [http://ec.europa.eu/priorities/sites/beta-political/files/italy\\_contribution\\_1\\_en.pdf](http://ec.europa.eu/priorities/sites/beta-political/files/italy_contribution_1_en.pdf) (accessed 17 February 2017)

<sup>242</sup> ‘To overcome political obstacles and build broad consensus, any mechanism must be based on gradualism in the shared effort and on an adequate medium-to-long term time horizon for implementation. Far-reaching political ambition is needed as well as a pragmatic approach to implement it.’, Contributions from the Sherpas of the Member States to the Five Presidents' Report: Italy, Second Contribution: 7-8, available at [http://ec.europa.eu/priorities/sites/beta-political/files/italy\\_contribution\\_2\\_en.pdf](http://ec.europa.eu/priorities/sites/beta-political/files/italy_contribution_2_en.pdf) (accessed 17 February 2017).

cause 'taxation is at the heart of democratic legitimacy'.<sup>243</sup> Lithuania, in turn, was skeptical of the idea of a fiscal capacity, and put accent on respecting the existing rules first, and only after some time it would be willing to consider further pooling of sovereignty in the fiscal realm. Lithuania, likewise, emphasized that any actions in this regard should consider the fact that 'tax policies belong to national competence'.<sup>244</sup>

### **vii.) limit on tax autonomy of the member states**

Spain had completely opposite views than Ireland. For Spain, the limitation of tax autonomy is a precondition for a fiscal union. The Spanish wanted to limit tax avoidance through the increase of budgetary harmonization among the member states and the introduction of a 'European fiscal identification number' in order to fight against 'aggressive tax planning, base erosion and profit shifting (BEPS)', also in tax heavens.<sup>245</sup>

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<sup>243</sup> 'Our position is that in any future proposal for further risk-sharing in the fiscal area, national competences and democratic processes would have to be respected. Ideally, a well-designed fiscal capacity would have three features, namely it would be: economically significant, automatic, and be fiscally neutral over the long term. (...) As taxation is at the heart of democratic legitimacy, moral hazard concerns should be not addressed by way of greater tax coordination. A mechanism which would involve the convergence of taxation systems would not be acceptable.', Contributions from the Sherpas of the Member States to the Five Presidents' Report: Ireland, First Contribution [no date]: 5, available at [http://ec.europa.eu/priorities/sites/beta-political/files/czech\\_contribution\\_2\\_en.pdf](http://ec.europa.eu/priorities/sites/beta-political/files/czech_contribution_2_en.pdf) (accessed 17 February 2017).

<sup>244</sup> 'Stronger common governance could be envisaged in the structural reform areas that are key for the smooth functioning of EMU. Yet, we have reservations whether this could be best achieved e.g. by common fiscal capacity; also we have to take into account that tax policies belong to national competence.', Contributions from the Sherpas of the Member States to the Five Presidents' Report: Lithuania [no date]: 3, available at [https://ec.europa.eu/priorities/sites/beta-political/files/lithuania\\_contribution\\_1\\_en.pdf](https://ec.europa.eu/priorities/sites/beta-political/files/lithuania_contribution_1_en.pdf) (accessed 17 February 2017).

<sup>245</sup> 'Harmonization of budgetary frameworks and fiscal alignment is also critical to advance towards a fiscal union. Insufficient levels of harmonization, coordination and transparency hamper the efficient functioning of the internal market. In this area, a first and urgent step is to ensure swift progress on measures against aggressive tax planning, base erosion and profit shifting (BEPS). Proposals: Approve new initiatives against aggressive tax planning, base erosion and profit shifting (BEPS). In particular, the EU should ensure swift implementation of proposals to favor the exchange



**viii.) a clearly assigned division of competences between the member states and the EU**

Spain was a strong advocate of a 'true' fiscal union, but one important precondition will have to be fulfilled, before moving to its final stage (including a common budget with own resources and borrowing powers): 'the budgetary responsibilities are clearly assigned between member States and the European level'.<sup>246</sup>

To sum up, in this section I listed the arguments of the member states, which I labeled as 'the preconditions for fiscalization'. These are:

- a.) a better national budget surveillance enforcement;
- b.) sound fiscal policies;
- c.) a link to structural reforms;
- d.) integrity of the single market and the rights of non-Euro Area member states;

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of information and the widest possible scope of application for the automatic exchange principle. Protect internal markets from tax avoidance and engage in transversal and coordinated actions with other countries in the fight against tax heavens. Take a close look in the fiscal treatment of hybrid instruments, the international fiscal rules, the rules against exit tax and so on. Introduce a European fiscal identification number that will facilitate the identification of tax payers that embark in cross-border operations.', Contributions from the Sherpas of the Member States to the Five Presidents' Report: Spain, First Contribution [no date]: 4-5, available at [https://ec.europa.eu/priorities/sites/beta-political/files/spain\\_contribution\\_1\\_en.pdf](https://ec.europa.eu/priorities/sites/beta-political/files/spain_contribution_1_en.pdf) (accessed 17 February 2017)., see also its second contribution: Contributions from the Sherpas of the Member States to the Five Presidents' Report: Spain, Second Contribution, 14 May 2015: 5, available at [https://ec.europa.eu/priorities/sites/beta-political/files/spain\\_contribution\\_2\\_en.pdf](https://ec.europa.eu/priorities/sites/beta-political/files/spain_contribution_2_en.pdf) (accessed 17 February 2017).

<sup>246</sup> 'Fiscal Union: Based on the analysis on public debt undertaken in stage II and once the budgetary responsibilities are clearly assigned between member States and the European level, the limited fiscal capacity could be enhanced to create a true Fiscal Union encompassing the three central elements (1) transfer of sovereignty on revenue and expenditure policies to the European level; 2) a common Eurozone budget; 3) common debt instruments. Participation in the Fiscal Union will be conditional to Member States achieving a significant degree of convergence, as demonstrated by sustained fulfillment of established criteria. Common debt instruments will be subject to controls and limits to ensure fiscal stability.', Contributions from the Sherpas of the Member States to the Five Presidents' Report: Spain, Second Contribution, 14 May 2015: 8, available at [https://ec.europa.eu/priorities/sites/beta-political/files/spain\\_contribution\\_2\\_en.pdf](https://ec.europa.eu/priorities/sites/beta-political/files/spain_contribution_2_en.pdf) (accessed 17 February 2017).

- e.) a gradual process;
- f.) respect for tax autonomy of the member states;
- g.) a limit on tax autonomy of the member states;
- h.) a clearly assigned division of competences between the member states and the EU.

The eight arguments presented above can be divided into three subgroups. The first one consists of the conditions that would have to be fulfilled by the member states, such as sound fiscal policies and structural reforms. The second group concerns the relation of fiscalization to the existing policies of the EU, and the member states, such the single market or the member states' tax autonomy. Interestingly, two arguments were contradictory. While countries benefiting from tax competition, for instance Ireland, argued that any fiscalization would need to respect the tax autonomy of the member states, others, such as Spain, argued exactly the opposite - fiscalization would need to be linked with a limitation of tax autonomy. The third subgroup concerns the relation between the EU and its member states. It was argued, for instance, that this gradual process would need to respect the rights of the non-Euro Area member states and be accompanied by 'a clearly assigned division of competences between the member states and the EU'. We can observe that a lot of reflection was done by the member states, which provided a comprehensive list of preconditions for fiscalization, a process that could bring about many positive consequences, a topic I delve deeper into in the following section.

### ***5.3.2 The positive consequences of fiscalization of the EU***

#### **i.) an investment tool for the creation of European public goods**

Significantly, it seems that it was clear for the member states that fiscalization would be, at least initially, limited to the Euro Area countries. However, Italy was one of a few member states, which envisioned using the EU budget, and not just the Euro Area future fiscal capacity, to invest in projects, which would create European public goods.<sup>247</sup> Such a solution would address ‘market failures’ and would be financed through a new ‘borrowing capacity’ with additional ‘direct support from Member states’.<sup>248</sup> Portugal also strongly supported fiscal capacity, which could be used to deliver European public goods, especially for the Euro Area.<sup>249</sup>

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<sup>247</sup> ‘In turn, the focus on European public goods could attract direct contribution to the Fund from Member states. The development of a borrowing capacity aimed at financing investments should also be considered. The forthcoming midterm review of the EU budget could be the chance also to reconsider the financing of the budget on the basis of the proposals of the Monti group on own resources with a view to the definition of a genuine Budget for Europe focused on European public goods.’, Contributions from the Sherpas of the Member States to the Five Presidents' Report: Italy, Second Contribution: 7, [http://ec.europa.eu/priorities/sites/beta-political/files/italy\\_contribution\\_2\\_en.pdf](http://ec.europa.eu/priorities/sites/beta-political/files/italy_contribution_2_en.pdf) (accessed 17 February 2017).

<sup>248</sup> ‘An effective use of the resources of the EU budget and of the Juncker Plan must address market failures in the financing of European public goods bringing the highest growth potential, possibly with direct support from Member states.’, Contributions from the Sherpas of the Member States to the Five Presidents' Report: Italy, Second Contribution: 3,6 [http://ec.europa.eu/priorities/sites/beta-political/files/italy\\_contribution\\_2\\_en.pdf](http://ec.europa.eu/priorities/sites/beta-political/files/italy_contribution_2_en.pdf) (accessed 17 February 2017).

<sup>249</sup> ‘Similarly, differences among national economies within the Euro Area both in their productivity levels and in their cyclical positions require a certain degree of fiscal intervention to foster convergence. Importantly, if that fiscal intervention is oriented toward further deepening the single market and delivering European public goods, the need of future fiscal intervention would actually be curtailed and the quality of our public policies would increase.’, Contributions from the Sherpas of the Member States to the Five Presidents' Report: Portugal, First Contribution [no date]: 3, available at [https://ec.europa.eu/priorities/sites/beta-political/files/portugal\\_contribution\\_1\\_en.pdf](https://ec.europa.eu/priorities/sites/beta-political/files/portugal_contribution_1_en.pdf) (accessed 17

## ii.) a stabilization mechanism to accommodate asymmetric shocks

Slovakia, Latvia, Poland and the Czech Republic were of a view that a fiscal capacity should 'function anti-cyclically' in order to accommodate 'self-perpetuating economic downturns' by reducing costs like unemployment.<sup>250</sup> It could also serve as an investment plan<sup>251</sup>, which would provide 'adjustment mechanisms'<sup>252</sup> and make the EMU shock resilient.<sup>253</sup> Currently, the EU budget is by far too small to fulfill these

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February 2017).

<sup>250</sup> 'Further, it should function anti-cyclically and eventually reduce excessive economic and social costs (e.g. obsoleting material and human capital, unemployment) of self-perpetuating economic downturns.', Contributions from the Sherpas of the Member States to the Five Presidents' Report: Czech Republic, Second Contribution, 15 May 2015: 3, available at [http://ec.europa.eu/priorities/sites/beta-political/files/czech\\_contribution\\_2\\_en.pdf](http://ec.europa.eu/priorities/sites/beta-political/files/czech_contribution_2_en.pdf) (accessed 17 February 2017).

<sup>251</sup> 'Slovakia is supportive of further integration among the euro area Member States in the fiscal realm; it is our view that the economic and monetary union cannot continue to exist in the long term unless fiscal instruments to address asymmetric and pan-European shocks become part of the EMU framework. In particular, a common unemployment insurance scheme to address asymmetric shocks by absorbing cyclical unemployment fluctuations as well as a common investment mechanism to address pan-EU shocks could serve this very purpose', Contributions from the Sherpas of the Member States to the Five Presidents' Report: Slovakia, First Contribution [no date]: 2-3, available at [https://ec.europa.eu/priorities/sites/beta-political/files/slovakia\\_contribution\\_1\\_en.pdf](https://ec.europa.eu/priorities/sites/beta-political/files/slovakia_contribution_1_en.pdf) (accessed 17 February 2017); see also: 'Response to macroeconomic and asymmetric shocks should be the primary function of a fiscal capacity– not a secondary characteristic attached to a budget designed for something else. Secondary functions of a fiscal capacity could include supporting social cohesion and European identity through the provision of direct benefits to our citizens. A common unemployment insurance scheme is particularly well-suited for these secondary issues.', Contributions from the Sherpas of the Member States to the Five Presidents' Report: Slovakia, Second Contribution [no date]: 2, available at [https://ec.europa.eu/priorities/sites/beta-political/files/slovakia\\_contribution\\_2\\_en.pdf](https://ec.europa.eu/priorities/sites/beta-political/files/slovakia_contribution_2_en.pdf) (accessed 17 February 2017).

<sup>252</sup> 'In the long term, the fiscal integration would also increase the effectiveness of adjustment mechanisms to asymmetric shocks in the Eurozone', Contributions from the Sherpas of the Member States to the Five Presidents' Report: Poland, First Contribution, [no date]: 5, available at [https://ec.europa.eu/commission/sites/beta-political/files/poland\\_contribution\\_1\\_en.pdf](https://ec.europa.eu/commission/sites/beta-political/files/poland_contribution_1_en.pdf) (accessed 17 February 2017).

<sup>253</sup> 'To make the euro area shock-resilient, a long-term perspective of moving towards a Fiscal Union should be envisaged. A Fiscal Union should be shaped along the lines identified in A Blueprint for a Genuine Economic and Monetary Union.' Contributions from the Sherpas of the Member States to the Five Presidents' Report: Latvia [no date]: 2, available at [https://ec.europa.eu/priorities/sites/beta-political/files/latvia\\_contribution\\_1\\_en.pdf](https://ec.europa.eu/priorities/sites/beta-political/files/latvia_contribution_1_en.pdf) (accessed 17 February 2017).

goals.<sup>254</sup> Likewise, Italy viewed a fiscal capacity as ‘euro area anti-cyclical buffer’<sup>255</sup> - a tool stabilizing the currency union through ‘cross-country transfers’, which would enable member states to ‘smooth demand in presence of negative shocks, avoid a too restrictive overall fiscal stance and minimize negative spillovers’.<sup>256</sup>

Likewise, Belgium and Austria envisioned shocks accommodating mechanism in a long term, but were much more skeptical in this regard and attached several conditions that would need to be fulfilled before such a measure could be implemented. Austria, for example, warned that such a stabilization mechanism would ‘pose far reaching constitutional questions’ and, if implemented, would need to be accompanied by measures reducing risks of moral hazard.<sup>257</sup> Belgium, on the other hand,

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<sup>254</sup> ‘In the ideal case, the countries participating in a monetary union would, besides the common monetary policy, share all other important aspects of economic policy. Currently, the financial size of the annual EU budget that is equal to around 1% of GDP of the European Union is highly insufficient for it to serve as a mechanism for actively coping with asymmetric shocks.’, Contributions from the Sherpas of the Member States to the Five Presidents' Report: Croatia, 27 March 2015, available at: [http://ec.europa.eu/priorities/sites/beta-political/files/croatia\\_contribution\\_1\\_en.pdf](http://ec.europa.eu/priorities/sites/beta-political/files/croatia_contribution_1_en.pdf) (accessed 17 February 2017).

<sup>255</sup> ‘In perspective a specific budget financed by own resources could evolve in a euro area anti-cyclical buffer with stabilization functions.’, Contributions from the Sherpas of the Member States to the Five Presidents' Report: Italy, Second Contribution: 7, available at [http://ec.europa.eu/priorities/sites/beta-political/files/italy\\_contribution\\_2\\_en.pdf](http://ec.europa.eu/priorities/sites/beta-political/files/italy_contribution_2_en.pdf) (accessed 17 February 2017).

<sup>256</sup> ‘In the longer term the development of a proper stabilization function to cope with asymmetric shock implies increasing degrees of fiscal integration and cross-country transfers financed by a common fiscal capacity. Such mechanisms, that are part and parcel of currency unions worldwide, would give individual countries the means to smooth demand in presence of negative shocks, avoid a too restrictive overall fiscal stance and minimize negative spillovers.’, Contributions from the Sherpas of the Member States to the Five Presidents' Report: Italy, Second Contribution: 7, available at [http://ec.europa.eu/priorities/sites/beta-political/files/italy\\_contribution\\_2\\_en.pdf](http://ec.europa.eu/priorities/sites/beta-political/files/italy_contribution_2_en.pdf) (accessed 17 February 2017), see also: ‘The framework for fiscal discipline enshrined in the SGP needs to be complemented by mechanisms allowing for a European orientation of fiscal policy. While maintaining sound budgetary positions in the medium and long term, the EMU needs to be capable of providing a coordinated fiscal policy stimulus in times of economic crisis or output growth below its potential.’, Contributions from the Sherpas of the Member States to the Five Presidents' Report: Spain, First Contribution [no date]: 4, available at [https://ec.europa.eu/priorities/sites/beta-political/files/spain\\_contribution\\_1\\_en.pdf](https://ec.europa.eu/priorities/sites/beta-political/files/spain_contribution_1_en.pdf) (accessed 17 February 2017).

<sup>257</sup> ‘In the medium to long-term, any proposals on further risk sharing on the Eurozone / EU-level (i.e. a fiscal capacity as a shock absorption mechanism) would have to go hand in hand with better enforcement of national budgetary policies in order to avoid the problem of moral-hazard. Further sharing of sovereignty, however, would pose far reaching constitutional questions’, Contributions from the Sherpas of the Member States to the Five Presidents' Report: Austria, 27

among its conditions, enumerated reducing debt levels and economic convergence<sup>258</sup>.

The Spanish view was that a fiscal union should be anti-cyclical, in order to help countries experiencing economic 'bad times'. Such a fiscal union would be based on a limited fiscal capacity, with borrowing powers, which would be used to finance public investments. A debt resulting from such borrowing would be subject to 'strict conditions and will be contingent on cyclical needs' and will have to be 'absorbed' in good times. It is not clear, however, if this debt will be used by the EU or if it will be lent to the member states. A fiscal union at this medium-term stage (2017-2019) would consist of a common debt management.<sup>259</sup> Similarly, Portugal was in favor of a fiscal capacity, which could absorb asymmetric shocks, which not always result from national policies. Such a union could take the form of an insur-

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April 2016: 2, available at [http://ec.europa.eu/priorities/sites/beta-political/files/austria\\_contribution\\_1\\_en\\_0.pdf](http://ec.europa.eu/priorities/sites/beta-political/files/austria_contribution_1_en_0.pdf) (accessed 17 February 2017).

<sup>258</sup> 'When all Member States are on a proven and determined path towards the Pact for Stability and Growth's debt reference value, and the necessary degree of economic, social and fiscal convergence has been achieved, a fiscal capacity and a treasury function for the euro area could be envisaged. This setup would provide for stabilisation, shock-absorption, adjustment and solidarity functions.', Contributions from the Sherpas of the Member States to the Five Presidents' Report: Belgium [no date]: 2, available at [http://ec.europa.eu/priorities/sites/beta-political/files/belgium\\_contribution\\_2\\_en.pdf](http://ec.europa.eu/priorities/sites/beta-political/files/belgium_contribution_2_en.pdf) (accessed 17 February 2017).

<sup>259</sup> 'Fiscal Union: The second phase of the fiscal union process involves the creation of a limited common fiscal capacity within the EMU. This fiscal capacity will be of a cyclical nature and linked to the financing of public investments. It will be financed by the EMU's own resources (to be defined) and will have limited borrowing capacity. To ensure its cyclical nature, debt emission will be subject to strict conditions and will be contingent on cyclical needs: Debt issued in 'bad times' will have to be absorbed in 'good times' thus preventing unsustainable debt accumulation dynamics. Another important feature of any fiscal union is common debt management. Currently the EMU is confronted to high stocks of public debt, both at the national level and in the EFSF/ESM framework. A reflection process, enshrined in a specific Green Paper, should be launched on the future of this debt within a fully-fledged fiscal union (third stage) with a view to preserve fiscal sustainability.', Contributions from the Sherpas of the Member States to the Five Presidents' Report: Spain, Second Contribution, 14 May 2015: 4, available at [https://ec.europa.eu/priorities/sites/beta-political/files/spain\\_contribution\\_2\\_en.pdf](https://ec.europa.eu/priorities/sites/beta-political/files/spain_contribution_2_en.pdf) (accessed 17 February 2017).

ance mechanism among the Euro Area countries, for instance as a European unemployment scheme.<sup>260</sup>

### iii.) democratic legitimacy and political union

Belgium linked the idea of a fiscal union with the notion that such a step will require more political integration and consequently action should be taken towards ‘a political union with a reinforced democratic legitimacy and accountability’.<sup>261</sup> Spain, on the other hand, advocated the creation of Eurozone Finance Ministry, which should be responsible for the newly created fiscal union. In the Spanish vision, which resembles the position of Belgium, fiscal integration must go hand in hand with political integration in order to ensure democratic accountability.<sup>262</sup> The latter

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<sup>260</sup> ‘Third, in the longer run and following a consensus in the euro area over complementary ways of funding, the EMF would also support limited shock absorbing instruments in order to improve the resilience of the euro area as a whole, prevent contagion across the Union, and reduce the economic and social costs associated with adjustments. This would respond to the need to find economic mechanisms that perform a stabilization role to deal with idiosyncratic shocks or asymmetrical effects of common shocks. While some of these shocks result from bad national policies, others do not. A shock-absorbing function would allow some sort of cross-border risk-sharing to help reduce adjustment costs for countries affected, limit the need to resort to financial assistance and prevent disruptions in social cohesion. Along the lines suggested by the Report prepared by the Four Presidents in 2012, this could take the general form of an insurance-type mechanism between the euro area countries and would require a greater degree of harmonization between economic policies and institutions of the participating Member States. The most obvious example of such a function would be a European complement or partial substitute to national unemployment insurance schemes, or partially europeanising active labour market policies.’, Contributions from the Sherpas of the Member States to the Five Presidents’ Report: Portugal, Second Contribution [no date]: 5, available at [https://ec.europa.eu/priorities/sites/beta-political/files/portugal\\_contribution\\_2\\_en.pdf](https://ec.europa.eu/priorities/sites/beta-political/files/portugal_contribution_2_en.pdf) (accessed 17 February 2017).

<sup>261</sup> ‘The progressive further integration of the euro area towards a full banking, fiscal and economic union would require parallel steps towards a political union with a reinforced democratic legitimacy and accountability based on shared sovereignty. This would require a thorough rethink of the role and balance of both EU and Member states’ institutions.’, Contributions from the Sherpas of the Member States to the Five Presidents’ Report: Belgium [no date]: 3, available at [http://ec.europa.eu/priorities/sites/beta-political/files/belgium\\_contribution\\_2\\_en.pdf](http://ec.europa.eu/priorities/sites/beta-political/files/belgium_contribution_2_en.pdf) (accessed 17 February 2017).

<sup>262</sup> ‘Political Union: Progress in economic integration has to be accompanied by deeper political integration. At this stage, an Authority responsible for economic policy in the Eurozone, sort of a Eurozone Minister of Finance, will be needed. This Authority would be responsible for the limited fiscal capacity already in place; would be in charge of the coordination and supervision of the convergence



position was also envisioned by Poland.<sup>263</sup>

#### **iv.) 'a favourable economic climate' and convergence**

Both Italy and the Czech Republic viewed a fiscal union as a way to improve economic conditions of the EMU. More specifically, the Czech Republic desired a fiscal capacity to protect the EU economy against 'susceptibility of being victim to global contagion'.<sup>264</sup> Italy focused on the political signal and 'positive economic expectations' that such a fiscal union would generate, which would lead to more stability and consequently to a 'more favorable economic climate'. Such solutions would also made it easier to execute necessary reforms.<sup>265</sup>

Similarly, Portugal argued that a fiscal capacity would allow for a 'fiscal intervention' in the Euro Area, which would bring 'positive shocks', required in a monetary

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process; and will promote the analysis of public debt management.(...) The Authority responsible for economic policy in the Eurozone will assume full responsibility for the EMU fiscal policy and will be granted direct sanction powers towards national administrations', Contributions from the Sherpas of the Member States to the Five Presidents' Report: Spain, Second Contribution, 14 May 2015:7-8, available at [https://ec.europa.eu/priorities/sites/beta-political/files/spain\\_contribution\\_2\\_en.pdf](https://ec.europa.eu/priorities/sites/beta-political/files/spain_contribution_2_en.pdf) (accessed 17 February 2017).

<sup>263</sup> 'In the long run such an action (i.e. to 'further Europeanise fiscal policy') would be desirable provided that (...) the level of political integration is increased and some competences in the area of economic and fiscal policy are transferred to the European level. (...) it would require an appropriate deepening of political integration', Contributions from the Sherpas of the Member States to the Five Presidents' Report: Poland, First Contribution, [no date]: 5, available at [https://ec.europa.eu/commission/sites/beta-political/files/poland\\_contribution\\_1\\_en.pdf](https://ec.europa.eu/commission/sites/beta-political/files/poland_contribution_1_en.pdf) (accessed 17 February 2017).

<sup>264</sup> 'It [fiscal capacity] should be used so as to increase the aggregate potential output of the EU economy and ensure its robustness in the global economy by reducing susceptibility of being victim to global contagion.' Contributions from the Sherpas of the Member States to the Five Presidents' Report: Czech Republic, Second Contribution, 15 May 2015: 3, available at [http://ec.europa.eu/priorities/sites/beta-political/files/czech\\_contribution\\_2\\_en.pdf](http://ec.europa.eu/priorities/sites/beta-political/files/czech_contribution_2_en.pdf) (accessed 17 February 2017).

<sup>265</sup> 'stability stemming from the strong political signal of deepened integration would create a more favorable economic climate that supports the reform efforts and triggers positive economic expectations.', Contributions from the Sherpas of the Member States to the Five Presidents' Report: Italy, first Contribution, 4-5, available at [http://ec.europa.eu/priorities/sites/beta-political/files/italy\\_contribution\\_1\\_en.pdf](http://ec.europa.eu/priorities/sites/beta-political/files/italy_contribution_1_en.pdf) (accessed 17 February 2017).



union consisting of diverse economies. What is more, such fiscal interventions should aim at 'deepening the single market and delivering European public goods', and consequently increase a likelihood of the economic convergence between these economies and decrease a possibility of future fiscal interventions.<sup>266</sup> For Portugal the crisis made it 'obvious' that there is a need for a fiscal capacity, especially for the Euro Area, since the members of the currency union lack major instruments of adjustments, which undermines their economic convergence.<sup>267</sup>

#### **v.) a link to own resources**

Spain already in 2012 published a paper entitled 'Towards European Fiscal Union', in which it provided details of such a union. Three years later, Spain recalled this contribution to the debates on the future of the EMU and maintained its position. Namely, it fully supported the creation of a 'fully-fledged fiscal union', with a risk-sharing mechanism in the areas of budget and debt.<sup>268</sup> Comparatively, Italy was

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<sup>266</sup> 'Similarly, differences among national economies within the Euro Area both in their productivity levels and in their cyclical positions require a certain degree of fiscal intervention to foster convergence. Importantly, if that fiscal intervention is oriented toward further deepening the single market and delivering European public goods, the need of future fiscal intervention would actually be curtailed and the quality of our public policies would increase. Finally, a new common policy in the toolkit of the Euro Zone would alleviate the heavy lifting being currently demanded to monetary policy which, in any case, cannot be sufficiently granular to deliver the kind of positive shocks that are sometimes required.', Contributions from the Sherpas of the Member States to the Five Presidents' Report: Portugal, First Contribution [no date]: 3, available at [https://ec.europa.eu/priorities/sites/beta-political/files/portugal\\_contribution\\_1\\_en.pdf](https://ec.europa.eu/priorities/sites/beta-political/files/portugal_contribution_1_en.pdf) (accessed 17 February 2017).

<sup>267</sup> 'Deepening the Economic and Monetary Union also requires some fiscal capacity. This need became obvious during the crisis. Fiscal capacity for the euro area alone is justified by the fact that euro-countries have fewer instruments to deal with necessary adjustments and also because making the bulk of adjustments depend solely on internal real depreciation undermines economic real convergence. In turn, deeper convergence diminishes considerably the risk of sovereign crisis and the need for financial assistance. This fiscal capacity should be funded by own resources and have access to financial markets.', Contributions from the Sherpas of the Member States to the Five Presidents' Report: Portugal, Second Contribution [no date]: 5, available at [https://ec.europa.eu/priorities/sites/beta-political/files/portugal\\_contribution\\_2\\_en.pdf](https://ec.europa.eu/priorities/sites/beta-political/files/portugal_contribution_2_en.pdf) (accessed 17 February 2017).

<sup>268</sup> 'In our view, a fully-fledged fiscal union should encompass a budgetary risk-sharing arrangement, joint decision making for a European orientation of fiscal policy and a certain level of risk pooling in debt issuance. These proposals are still valid and need to be approached in the medium to long term', Contributions from the Sherpas of the Member States to the Five Presidents' Report:

open to various ideas how the new fiscal union could be financed. Consequently, Italy enumerated a number of options, such as ‘pooling resources from Member states; issuances based on an implicit EU budget guarantee as it is the case of Balance of Payment and Macro financial assistances; a specific Euro budget line with distinct funds and functions to be financed with a new tax base like carbon tax, digital taxation, FTT etc.’<sup>269</sup>

Portugal provided perhaps the strongest arguments in favor of own resources and made it crystal clear that a future fiscal capacity should not be based on national contributions, as is currently the case with both the EU budget and the ESM, but should be based on truly own resources. This is due to the fact that a system based on the national contributions creates a zero sum game, in which it is very easy to calculate how much each country pays and receives from the common resources. This, in turn, leads to a perception that some countries are (unfairly) redistributing federal resources to the others. Such a system based on national resources has ‘too high political transaction costs’ and may lead to political hostility between the member states and - as a result - undermine the European project as a whole.<sup>270</sup> The

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Spain, First Contribution [no date]: 5, available at [https://ec.europa.eu/priorities/sites/beta-political/files/spain\\_contribution\\_1\\_en.pdf](https://ec.europa.eu/priorities/sites/beta-political/files/spain_contribution_1_en.pdf) (accessed 17 February 2017).

<sup>269</sup> ‘Possible initiatives may differ in scope or ways of financing (pooling resources from Member states; issuances based on an implicit EU budget guarantee as it is the case of Balance of Payment and Macro financial assistances; a specific Euro budget line with distinct funds and functions to be financed with a new tax base like carbon tax, digital taxation, FTT etc.) but they must include the common element of the full commitment of Member states to a shared long term vision. This is important as it anchors economic expectations to perspectives of more prosperity and stability with an immediate impact on the economy even if the realization of the project is for the long run.’, Contributions from the Sherpas of the Member States to the Five Presidents' Report: Italy, Second Contribution: 8, available at [http://ec.europa.eu/priorities/sites/beta-political/files/italy\\_contribution\\_2\\_en.pdf](http://ec.europa.eu/priorities/sites/beta-political/files/italy_contribution_2_en.pdf) (accessed 17 February 2017).

<sup>270</sup> ‘So far the Union has compensated for the lack of appropriate fiscal capacity by pooling national financial resources. This happens, for example, with the ESM or, to some extent, with the new investment plan. This approach is fraught with difficulties. By linking the fiscal capacity of the euro area to national financial resources, any intervention becomes a zero-sum game and a form of redistribution of the resources of some States to other States. This generates too high political transaction costs and hinders the capacity to act effectively on the part of the euro area. Ultimately, it also corrodes the social and political foundations of European integration.’, Contributions from the Sherpas of the Member States to the Five Presidents' Report: Portugal, Second Contribution [no date]: 5, available at [https://ec.europa.eu/priorities/sites/beta-political/files/portugal\\_contribution\\_2\\_en.pdf](https://ec.europa.eu/priorities/sites/beta-political/files/portugal_contribution_2_en.pdf)

position of Portugal was, therefore, that a fiscal capacity should be based on own resources, raised from the entities that benefit most from the existence of the euro. Additionally, such a capacity should be fiscally neutral for the member states and should not undermine the single market.<sup>271</sup> It should also have a borrowing power.<sup>272</sup>

Portugal seemed to argue that the discussion about a fiscal union should start with finding an agreement that such a union will have to be financed through its own resources, rather than national contributions. Only then member states can 'discuss seriously the policies to be funded by such resources'. The Portuguese position seemed to go against the call of some member states arguing that a fiscal union should not lead to permanent transfers between countries.<sup>273</sup>

Nevertheless, Portugal seemed to argue that one could talk about such transfers only if a European fiscal union would be based on national resources. If the fiscal capacity is based on common resources, as the reasoning goes, there is no such a thing as 'transfers between countries', as these transfers do not flow between coun-

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(accessed 17 February 2017).

<sup>271</sup> 'Portugal argues that that kind of fiscal intervention should take place via a budgetary capacity for the Euro Zone. The exact design of a such an instrument is open to further discussion, but a few features should be granted: a Euro Zone-only instrument, but not putting into question the integrity of the single market; funded by own resources and in a fiscally-neutral way for member states; own resources based on economic sectors that have gained most from the common currency, and which have a strong transnational dimension.', Contributions from the Sherpas of the Member States to the Five Presidents' Report: Portugal, First Contribution [no date]: 3, available at [https://ec.europa.eu/priorities/sites/beta-political/files/portugal\\_contribution\\_1\\_en.pdf](https://ec.europa.eu/priorities/sites/beta-political/files/portugal_contribution_1_en.pdf) (accessed 17 February 2017).

<sup>272</sup> 'This fiscal capacity should be funded by own resources and have access to financial markets.', Contributions from the Sherpas of the Member States to the Five Presidents' Report: Portugal, Second Contribution [no date]: 5, available at [https://ec.europa.eu/priorities/sites/beta-political/files/portugal\\_contribution\\_2\\_en.pdf](https://ec.europa.eu/priorities/sites/beta-political/files/portugal_contribution_2_en.pdf) (accessed 17 February 2017).

<sup>273</sup> 'As long as the Member States are as heterogeneous as they are today, creation of a possible fiscal capacity would in effect entail a transfer union and expand joint liability. Therefore considering a fiscal capacity is not realistic before a much closer economic convergence among the Member States has been achieved, including of debt levels.', Contributions from the Sherpas of the Member States to the Five Presidents' Report: Finland, Second Contribution, 15 May 2015: 3, available at [http://ec.europa.eu/priorities/sites/beta-political/files/austria\\_contribution\\_1\\_en\\_0.pdf](http://ec.europa.eu/priorities/sites/beta-political/files/austria_contribution_1_en_0.pdf) (accessed 17 February 2017).

tries, but from the EU (Euro Area) level - it is vertical, rather than horizontal. This observation does not go against a principle that the transfers should be cyclical and should not undermine fiscal responsibility of the member states. Furthermore, such a European budget cannot create more fiscal obligations for the European citizens. On the contrary - it has to be fiscally neutral. It seems that Portugal saw fiscal capacity as a way to raise resources that could only be effectively raised at the EU level, otherwise member states would not be able to access such a tax base (e.g. multinational companies, which would otherwise avoid taxes by moving between countries). Significantly, Portugal very strongly argued that there are political reasons on why it is important on 'how' the money is obtained, and not so much 'how much': 'It is not about how much it is paid but how it is paid'.<sup>274</sup>

Slovakia, on the other hand, was against joining a fiscal capacity with the EU budget, which is concerned with long term growth. Fiscal capacity, in turn, 'must be designed to stimulate a countercyclical fiscal stance'.<sup>275</sup>

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<sup>274</sup> 'Furthermore, this way alone will allow us to legitimate common responsibility within the Union on any meaningful and lasting basis. The European Commission should consider the several technical options available, but from a political point of view it would be important that this assumption of common responsibilities be related to the different degree to which different social/economic groups benefit from European integration and, particularly, the single currency. Obviously, regardless of which option is ultimately to be taken, strict fiscal neutrality for European citizens must be guaranteed. Likewise, it must fully preserve the integrity of the Single Market. It is not about how much it is paid but how it is paid.', Contributions from the Sherpas of the Member States to the Five Presidents' Report: Portugal, Second Contribution [no date]: 7, available at [https://ec.europa.eu/priorities/sites/beta-political/files/portugal\\_contribution\\_2\\_en.pdf](https://ec.europa.eu/priorities/sites/beta-political/files/portugal_contribution_2_en.pdf) (accessed 17 February 2017).

<sup>275</sup> 'A critical point needs to be made that any instrument acting as a fiscal capacity must be totally separate from the EU budget. The two serve entirely different purposes. The EU budget is concerned with long-term growth and investment, whereas the fiscal capacity must be designed to simulate a countercyclical fiscal stance. Financing of the fiscal capacity could be inspired by the results of the work on own resources of the HLGOR led by Mario Monti.', Contributions from the Sherpas of the Member States to the Five Presidents' Report: Slovakia, Second Contribution [no date]: 2, [https://ec.europa.eu/priorities/sites/beta-political/files/slovakia\\_contribution\\_2\\_en.pdf](https://ec.europa.eu/priorities/sites/beta-political/files/slovakia_contribution_2_en.pdf) (accessed 17 February 2017).

## vi.) the use of the European Stability Mechanism

As a result of its deliberations on the importance of a fiscal capacity based on own resources, and not on national contributions, Portugal called for the creation of a European Monetary and Fiscal Fund (EMFF) in the last stage of fiscal integration.<sup>276</sup> The creation of such a fiscal capacity in the form of the EMFF should come after a short term solution, which would be based on a reformed ESM.<sup>277</sup> Portugal argued that the ESM should be changed in such a way that using its resources would not have a stigma of the assistance programs. Rather, borrowing from the ESM should be considered as a normal part of the functioning in the single currency area.<sup>278</sup>

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<sup>276</sup> 'The sources of EMF revenues should be in the future determined by what makes the European project more legitimate to its citizens whilst making visible the reasons for its existence and the economic activity it generates or regulates. In an appropriate stage of integration, priority should be given to consider euro area own resources to fund this fiscal capacity. Once this capacity is integrated into the Fund, its designation would have to reflect this specific capability. Therefore, we propose to call it at that stage European Monetary and Fiscal Fund (EMFF). It is only by detaching euro area own resources from national contributions that we can create the conditions for the Union to discuss seriously the policies to be funded by such resources.' Contributions from the Sherpas of the Member States to the Five Presidents' Report: Portugal, Second Contribution [no date]: 6-7, available at [https://ec.europa.eu/priorities/sites/beta-political/files/portugal\\_contribution\\_2\\_en.pdf](https://ec.europa.eu/priorities/sites/beta-political/files/portugal_contribution_2_en.pdf) (accessed 17 February 2017).

<sup>277</sup> 'However, as regards the time sequencing, it seems reasonable to outline the following priorities: 1 - accelerate the implementation of the Banking and Financial Union; 2 – create in the short-term a EMF incorporating the ESM; 3 – establish in the longer-term a fiscal capacity for the euro area, thus transforming the EMF into a EMFF.', Contributions from the Sherpas of the Member States to the Five Presidents' Report: Portugal, Second Contribution [no date]: 8, available at [https://ec.europa.eu/priorities/sites/beta-political/files/portugal\\_contribution\\_2\\_en.pdf](https://ec.europa.eu/priorities/sites/beta-political/files/portugal_contribution_2_en.pdf) (accessed 17 February 2017).

<sup>278</sup> 'The political argument calling for a budgetary capacity with own resources equally applies to the way the European Stability Mechanism (ESM) works. Member states and institutions should work in order to de-politicise the ESM and bring it more in line with a true European Monetary Fund, perceiving financial assistance as an ordinary instrument of a single currency area and limiting henceforth the bias toward looking at the ESM as a beefed-up version of bilateral financial assistance. The Eurogroup would of course play a political monitoring role and full conditionality to lending would apply but political arguments between creditors and debtors and fractures along national lines should be prevented in the future.', Contributions from the Sherpas of the Member States to the Five Presidents' Report: Portugal, First Contribution [no date]: 3, available at [https://ec.europa.eu/priorities/sites/beta-political/files/portugal\\_contribution\\_1\\_en.pdf](https://ec.europa.eu/priorities/sites/beta-political/files/portugal_contribution_1_en.pdf) (accessed 17 February 2017).

Importantly, both Italy and Portugal developed a comprehensive plan for transferring the ESM into a European Monetary Fund (EMF).<sup>279</sup> The main aim of the EMF would be to provide financial assistance for infrastructure investments and structural reforms. Such mechanisms would, in turn, foster the ‘symmetric macroeconomic stance’ of the EMU.<sup>280</sup> Italy saw the creation of the EMF as a medium-term goal, and in a shorter perspective the ‘abundant’ resources of the existing ESM should be used to create a backstop for the banking union. A reformed ESM should also ‘support growth and investment initiatives at EU level’.<sup>281</sup> Thus, the positions of these two Southern countries on how the ESM should be reformed were quite similar.

To sum up, in this section I listed the arguments of the member states which I labeled ‘the positive consequences of fiscalization’. Those arguments are:

a.) an investment tool for the creation of European public goods;

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<sup>279</sup> I have no knowledge, however, if the two countries coordinated their positions on that matter.

<sup>280</sup> ‘fundamental element of this reformed architecture of the euro is a European Monetary Fund (EMF). (...) Second, the EMF would be endowed with fiscal capacity in order to finance national structural reforms (according to a mutually agreed understanding and with proper conditionality) with positive spillovers to the euro area as a whole, as well as investment projects focused on expanding or modernizing the infrastructure upon which the Single Market depends – much along the lines defined by the Juncker investment plan. Importantly, acting as a catalyst for investment, the fiscal capacity would contribute to internal rebalancing within the euro area and therefore to a more symmetric macroeconomic stance. This function should be activated whenever deemed necessary and does not have to be fulfilled as a permanent device.’, Contributions from the Sherpas of the Member States to the Five Presidents’ Report: Portugal, Second Contribution [no date]: 5-6, available at [https://ec.europa.eu/priorities/sites/beta-political/files/portugal\\_contribution\\_2\\_en.pdf](https://ec.europa.eu/priorities/sites/beta-political/files/portugal_contribution_2_en.pdf) (accessed 17 February 2017).

<sup>281</sup> ‘Finally, the debate about deepening the EMU cannot but consider the role of ESM in the governance framework. This institution played a crucial role in the management of the crisis. It is endowed with abundant resources which need to be efficiently exploited while safeguarding the firewall mission of the institution. Several options for the evolving role of ESM have been elaborated, the most ambitious one being the transformation in a European Monetary Fund. An ambitious goal we may want to realize in the medium term. In a shorter perspective there is scope for developing concrete proposals aimed to effectively exploit ESM capacity to provide a common backstop within the framework of the banking union and for exploring how ESM could support growth and investment initiatives at EU level.’, Contributions from the Sherpas of the Member States to the Five Presidents’ Report: Italy, Second Contribution: 8, [http://ec.europa.eu/priorities/sites/beta-political/files/italy\\_contribution\\_2\\_en.pdf](http://ec.europa.eu/priorities/sites/beta-political/files/italy_contribution_2_en.pdf) (accessed 17 February 2017).

- b.) a stabilization mechanism to accommodate asymmetric shocks;
- c.) democratic legitimacy and political union;
- d.) 'a favourable economic climate' and convergence;
- e.) a link to own resources;
- f.) a link to the European Stability Mechanism.

Thus, I listed the arguments of this section into six main categories. One argument is especially relevant for my theoretical framework, namely the one that regarded fiscalization as 'a stabilization mechanism to accommodate asymmetric shocks'. This argument is an evidence that a threat emerging from such an economic shock played an important role in the deliberation on fiscalization. The two other arguments also envision, albeit less directly, a possibility to shield from a future threat, but in positive terms. Accordingly, fiscalization would lead to the creation of European public goods, such as a common defense policy. Moreover, by encouraging a 'favourable economic climate', fiscalization would lead to the convergence of the less affluent member states. Whereas those arguments did not relate to the current threat as resulted from the Euro crisis, their use nevertheless shows that fiscalization is linked to a threat of economic recession.

Moreover, some member states envisioned that the debate on fiscalization should be linked not only to the ESM, but to the ongoing discussion on the reform of the EU budget and its own resources. All in all, it seems that the member states were aware of the paradigmatic shift that fiscalization would bring about. For this reason, some of them argued that such a change would have to be accompanied with more political accountability and democratic control. As a result, and perhaps paradoxically, triggering fiscalization at the EU level would help to solve its democratic deficit. This would be done by the creation of a political union, which would complete a

fiscal union. Nevertheless, not all of the member states regarded fiscalization as bringing positive effects, a topic I will discuss in more detail in the following section.



### ***5.3.3 The negative consequences of fiscalization of the EU***

Many countries highlighted the possibility of the negative consequences of fiscalization, but a majority of them were still in favor of this solution, provided that the mechanisms preventing such negative consequences would be established. A very few countries, namely Finland, the Netherlands and Malta, opposed fiscal capacity as such.

#### **i.) permanent transfers between countries**

The Czech Republic held a position that fiscal capacity should not lead to ‘new long-term unidirectional flows within the EU.’<sup>282</sup> Rather, it should prevent the emergence of the macroeconomic imbalances.<sup>283</sup> Likewise, Denmark worried that a fiscal capacity aiming at ‘automatic stabilization’ would lead to ‘permanent transfers from Member States with for instance low structural unemployment to those with high structural unemployment etc’.<sup>284</sup> Estonia was also against the possibility

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<sup>282</sup> Contributions from the Sherpas of the Member States to the Five Presidents' Report: Czech Republic, Second Contribution, 15 May 2015: 3, available at [http://ec.europa.eu/priorities/sites/beta-political/files/czech\\_contribution\\_2\\_en.pdf](http://ec.europa.eu/priorities/sites/beta-political/files/czech_contribution_2_en.pdf) (accessed 17 February 2017).

<sup>283</sup> ‘Fiscal capacity cannot serve as a macroeconomic adjustment tool, but must be a preventive part of macroeconomic imbalances, not their resolution tool (especially not repetitive).’, Contributions from the Sherpas of the Member States to the Five Presidents' Report: Czech Republic, Second Contribution, 15 May 2015: 3, available at [http://ec.europa.eu/priorities/sites/beta-political/files/czech\\_contribution\\_2\\_en.pdf](http://ec.europa.eu/priorities/sites/beta-political/files/czech_contribution_2_en.pdf) (accessed 17 February 2017).

<sup>284</sup> ‘Labour market and welfare institutions as well as the structure and level of taxation etc. differ significantly among Member States according to political preferences. This makes it difficult to achieve automatic stabilization across the euro area without introducing permanent transfers from Member States with for instance low structural unemployment to those with high structural unemployment etc.’, Contributions from the Sherpas of the Member States to the Five Presidents' Report:

of transfers between the member states and wrote that the focus should be on actions at the national level - either in the form of sound economic policies ('delivering key reforms and meeting fiscal targets') or a 'reserve fund', as a preferred alternative to a fiscal capacity at the Euro Area level.<sup>285</sup> By the same token, the Portuguese favored fiscal capacity, but without 'ad hoc' transfers, which would lead to bargaining between countries. Such bargaining would be 'politically bruising' and would consequently risk fragmentation of the Euro Area and the 'irreversibility' of the euro.<sup>286</sup> Contrary to the above-mentioned countries, Finland not only opposed the transfers, but the idea of a fiscal union as such, because it would 'in effect entail a transfer union and expand joint liability'. For this reason, the focus should be on the economic convergence which should take place first.<sup>287</sup>

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Denmark, 26 March 2016: 4, available at [https://ec.europa.eu/priorities/sites/beta-political/files/denmark\\_contribution\\_1\\_en.pdf](https://ec.europa.eu/priorities/sites/beta-political/files/denmark_contribution_1_en.pdf) (accessed 17 February 2017).

<sup>285</sup> 'Progress on further fiscal integration should be path-dependent. It should focus on delivering key reforms and meeting fiscal targets. In the long-term, Estonia does not exclude the idea of limited euro area budgetary capability. However, we would prefer a reserve fund type solutions at the national level. The focus should be on delivery of key reforms and meeting of the targets rather than generating mechanisms of transfer.', Contributions from the Sherpas of the Member States to the Five Presidents' Report: Estonia [no date]: 1-2, available at [https://ec.europa.eu/priorities/sites/beta-political/files/estonia\\_contribution\\_1\\_en.pdf](https://ec.europa.eu/priorities/sites/beta-political/files/estonia_contribution_1_en.pdf) (accessed 17 February 2017).

<sup>286</sup> 'There is also a political reasoning behind this. Euro Zone's institutions should be built in a way that limits ad hoc transfers among member states which are politically bruising and may ultimately lead to hard intergovernmental bargaining. That is something to be avoided, and in particular the Euro Zone, since the risk of fragmentation may become self-fulfilling and the irreversibility of the Euro is an intangible asset whose credibility rests on each of the member states (...)', Contributions from the Sherpas of the Member States to the Five Presidents' Report: Portugal, First Contribution [no date]: 3, available at [https://ec.europa.eu/priorities/sites/beta-political/files/portugal\\_contribution\\_1\\_en.pdf](https://ec.europa.eu/priorities/sites/beta-political/files/portugal_contribution_1_en.pdf) (accessed 17 February 2017).

<sup>287</sup> 'As long as the Member States are as heterogeneous as they are today, creation of a possible fiscal capacity would in effect entail a transfer union and expand joint liability. Therefore considering a fiscal capacity is not realistic before a much closer economic convergence among the Member States has been achieved, including of debt levels.', Contributions from the Sherpas of the Member States to the Five Presidents' Report: Finland, Second Contribution, 15 May 2015: 3, available at [http://ec.europa.eu/priorities/sites/beta-political/files/austria\\_contribution\\_1\\_en\\_0.pdf](http://ec.europa.eu/priorities/sites/beta-political/files/austria_contribution_1_en_0.pdf) (accessed 17 February 2017).

## ii.) moral hazard

A future fiscal capacity, if agreed, should be based on an ‘appropriate conditionality to address moral hazard problems’, as Cyprus stated.<sup>288</sup> Likewise, Italy was advocating the creation of a mechanism that would ensure that the member states continue to pursue sound fiscal policies, even in the presence of a stabilization mechanism (i.e. the main element of fiscal capacity).<sup>289</sup> Quite similarly, Ireland stated that ‘any form of insurance mechanism’ at the EU level would risk moral hazard, which should be avoided.<sup>290</sup> Austria<sup>291</sup> and the Czech Republic similarly warned against the danger of moral hazard that ‘sharing of fiscal risks’ may lead to.<sup>292</sup> Estonia put it

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<sup>288</sup> ‘(...) further risk-sharing in the fiscal realm between member states if examined, should of course be viewed in the context of an appropriate conditionality to address moral hazard problems.’, Contributions from the Sherpas of the Member States to the Five Presidents' Report: Cyprus: 3, available at [http://ec.europa.eu/priorities/sites/beta-political/files/italy\\_contribution\\_1\\_en.pdf](http://ec.europa.eu/priorities/sites/beta-political/files/italy_contribution_1_en.pdf) (accessed 17 February 2017).

<sup>289</sup> ‘What is currently needed is the design of an appropriate incentive structure to ensure that Member states continue to pursue sound fiscal policies in presence of a stabilization mechanism. These incentives must be built in such a way as to limit moral hazard and avoid permanent transfers from some countries to others; for example the likelihood of using the shared resources must be largely outside the control of national government’, Contributions from the Sherpas of the Member States to the Five Presidents' Report: Italy, Second Contribution: 7, available at [http://ec.europa.eu/priorities/sites/beta-political/files/italy\\_contribution\\_2\\_en.pdf](http://ec.europa.eu/priorities/sites/beta-political/files/italy_contribution_2_en.pdf) (accessed 17 February 2017).

<sup>290</sup> ‘However, adequate consideration must be given to addressing the risk of moral hazard which would arise with the creation of any form of insurance mechanism at the central level.’, Contributions from the Sherpas of the Member States to the Five Presidents' Report: Ireland, First Contribution [no date]: 5, available at [http://ec.europa.eu/priorities/sites/beta-political/files/czech\\_contribution\\_2\\_en.pdf](http://ec.europa.eu/priorities/sites/beta-political/files/czech_contribution_2_en.pdf) (accessed 17 February 2017).

<sup>291</sup> ‘In the medium to long-term, any proposals on further risk sharing on the Eurozone/ EU-level (i.e. a fiscal capacity as a shock absorption mechanism) would have to go hand in hand with better enforcement of national budgetary policies in order to avoid the problem of moral-hazard. Further sharing of sovereignty, however, would pose far reaching constitutional questions.’, Contributions from the Sherpas of the Member States to the Five Presidents' Report: Austria, 27 April 2016: 2, available at [http://ec.europa.eu/priorities/sites/beta-political/files/austria\\_contribution\\_1\\_en\\_0.pdf](http://ec.europa.eu/priorities/sites/beta-political/files/austria_contribution_1_en_0.pdf) (accessed 17 February 2017).

<sup>292</sup> ‘To ensure that sharing of fiscal risks does not lead to a substantial moral hazard of countries because of their fiscally or in other way irresponsible behavior, it should be enabled only if there is a better enforcement of responsible behavior of national authorities.’, Contributions from the Sherpas of the Member States to the Five Presidents' Report: Czech Republic, First Contribution: 3, available at [http://ec.europa.eu/priorities/sites/beta-political/files/czech\\_contribution\\_1\\_en.pdf](http://ec.europa.eu/priorities/sites/beta-political/files/czech_contribution_1_en.pdf) (accessed 17 February 2017).

simply: ‘(m)oral hazard must be avoided’ and later again confirmed that any future ‘common risk sharing’ should encourage meeting fiscal goals.<sup>293</sup>

By the same token, Denmark worried about the risk of moral hazard and that ‘[c]ommon debt issuance (e.g. Eurobonds) or a central spending capacity (e.g. a euro area budget for automatic stabilization or discretionary spending)’ does not deal with rules compliance, which is crucial for the proper functioning of the EMU. Such a fiscal capacity may create moral hazard, as it would discourage countries to undertake ‘structural policies’, as ‘relations between national spending, taxation, and debt financing are weakened.’<sup>294</sup>

Similarly, Luxembourg’s precondition for a further risk sharing in the fiscal area was the creation of a ‘level playing field’ for all member states, and the common institutions with an ‘appropriate enforcement powers’, which would lead to ‘minimizing the risk of free-riding’.<sup>295</sup> The UK also supported the idea of fiscal capacity, but first all the rules and mechanisms of the fiscal coordination should be fully implemented. In addition, if such a fiscal capacity (the UK enumerated several ideas in

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<sup>293</sup> ‘Neither the current situation in the Member States nor the level of integration provide for a stable environment for common risk sharing, such as, but not limited to common bond issuance. Any future system should be supportive of fiscal targets and it should strengthen market signals.’, Contributions from the Sherpas of the Member States to the Five Presidents’ Report: Estonia [no date]:2 available at [https://ec.europa.eu/priorities/sites/beta-political/files/estonia\\_contribution\\_1\\_en.pdf](https://ec.europa.eu/priorities/sites/beta-political/files/estonia_contribution_1_en.pdf) (accessed 17 February 2017).

<sup>294</sup> ‘It is the view of Denmark that rule compliance is key to address the challenges for the EMU. Common debt issuance (e.g. eurobonds) or a central spending capacity (e.g. a euro area budget for automatic stabilization or discretionary spending) does not address rule compliance and could risk diminishing incentives for structural policies as the relations between national spending, taxation, and debt financing are weakened.’, Contributions from the Sherpas of the Member States to the Five Presidents’ Report: Denmark, 26 March 2016: 4, available at [https://ec.europa.eu/priorities/sites/beta-political/files/denmark\\_contribution\\_1\\_en.pdf](https://ec.europa.eu/priorities/sites/beta-political/files/denmark_contribution_1_en.pdf) (accessed 17 February 2017).

<sup>295</sup> ‘Further risk-sharing must go hand in hand with i) the definition of a clear legal framework minimizing the risk of free-riding and guaranteeing a level playing across Member states, and ii) the establishment of common institutions with a clear mandate and appropriate enforcement powers.’, Contributions from the Sherpas of the Member States to the Five Presidents’ Report: Luxembourg [no date]: 7, available at [https://ec.europa.eu/priorities/sites/beta-political/files/luxembourg\\_contribution\\_1\\_en.pdf](https://ec.europa.eu/priorities/sites/beta-political/files/luxembourg_contribution_1_en.pdf) (accessed 11 March 2017).

this regard: 'stronger rules/limits on national fiscal policies; a more closely coordinated euro area fiscal policy to deliver an agreed fiscal stance; a counter-cyclical budget at the euro area level; common issuance of member states' debt; and, a transfer union via a large euro area budget'), then the issue of the 'economic and fiscal' risks would need to be addressed.<sup>296</sup> Crucially, after Brexit, the preferences of the UK are not likely to be taken into account by the other member states. Nevertheless, until Brexit has taken place, the UK still has a veto power.

Three member states – Finland, Netherlands, and Malta - were of a position that fiscal union is unnecessary. Finland held a view that a fiscal union is not necessary, even in the long run, because structural reforms and a banking union would be much better solutions. The latter would also 'be much more effective in buffering asymmetric shocks than a Euro Area fiscal capacity.'<sup>297</sup> Similarly, the Netherlands was against the idea of a 'realm of further [fiscal] risk sharing, new competences or institutions', which at this stages is 'premature'.<sup>298</sup> In its second contribution, the

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<sup>296</sup> 'Looking beyond this, most other currency unions have closer fiscal integration than is currently the case for the euro area. Options that have been discussed to advance these objectives range from: stronger rules/limits on national fiscal policies; a more closely coordinated euro area fiscal policy to deliver an agreed fiscal stance; a counter-cyclical budget at the euro area level; common issuance of MS debt; and, a transfer union via a large euro area budget. The Commission also set out ideas in March 2013 in its Communication on a Convergence and Competitiveness Instrument to link implementation of structural reforms essential to the smooth functioning of EMU to payments from a euro area solidarity fund, recognising that there may be short-term costs of implementing such reforms. In addition, further moves toward closer fiscal integration would clearly need to be taken in tandem with policies and mechanisms to address the economic and fiscal risks that would otherwise be created.', Contributions from the Sherpas of the Member States to the Five Presidents' Report: UK, Second Contribution, [no date]: 3-4, available at [https://ec.europa.eu/priorities/sites/beta-political/files/uk\\_contribution\\_2\\_en.pdf](https://ec.europa.eu/priorities/sites/beta-political/files/uk_contribution_2_en.pdf) (accessed 17 February 2017).

<sup>297</sup> 'Even in a long-term there is no need to create a financial mechanism compensating for structural reforms which are beneficial as such. Moreover, a well-functioning banking union would be much more effective in buffering asymmetric shocks than a Euro Area fiscal capacity.', Contributions from the Sherpas of the Member States to the Five Presidents' Report: Finland, Second Contribution, 15 May 2015: 3, available at [http://ec.europa.eu/priorities/sites/beta-political/files/austria\\_contribution\\_1\\_en\\_0.pdf](http://ec.europa.eu/priorities/sites/beta-political/files/austria_contribution_1_en_0.pdf) (accessed 17 February 2017).

<sup>298</sup> 'Addressing questions in the realm of further risk sharing, new competences or institutions in the Four Presidents' Report is premature.', Contributions from the Sherpas of the Member States to the Five Presidents' Report: Netherlands, First Contribution, March 2015: 3, available at

Netherlands argued for an agenda for a better governance at the national level, and it opposed any further transfer of competences to the EU level.<sup>299</sup> By the same token, Malta was simply against the idea of a ‘fully fledged fiscal union’, while remaining open to explore other possibilities of the risk sharing.<sup>300</sup> Furthermore, Malta believed that the existing instruments created at the beginning of the crisis, namely the ESM and the actions of the ECB, are enough to absorb the asymmetric shocks in the Euro Area. Consequently, Malta was against the creation of a fiscal capacity. The main reason Malta gave to support its position was the principle of subsidiarity, which should be respected especially in the area of ‘taxes and the management of tax collection’.<sup>301</sup>

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[http://ec.europa.eu/priorities/sites/beta-political/files/austria\\_contribution\\_1\\_en\\_0.pdf](http://ec.europa.eu/priorities/sites/beta-political/files/austria_contribution_1_en_0.pdf) (accessed 17 February 2017).

<sup>299</sup> ‘We argue that we need a Better Governance Agenda to bring elements like these together and put them to work for growth and jobs. Not to transfer competences to a higher EU level, but to strengthen our sovereign governance at home and thereby buttressing the whole.’, Contributions from the Sherpas of the Member States to the Five Presidents’ Report: Netherlands, Second Contribution, March 2015: 1, available at [http://ec.europa.eu/priorities/sites/beta-political/files/netherlands\\_contribution\\_2\\_en\\_0.pdf](http://ec.europa.eu/priorities/sites/beta-political/files/netherlands_contribution_2_en_0.pdf) (accessed 17 February 2017); ‘Better Governance is not about further transfer of competences. (...) Better Governance is also not an elaborate new framework with institutions.’, Contributions from the Sherpas of the Member States to the Five Presidents’ Report: Netherlands, Second Contribution, March 2015: 2, available at [http://ec.europa.eu/priorities/sites/beta-political/files/netherlands\\_contribution\\_2\\_en\\_0.pdf](http://ec.europa.eu/priorities/sites/beta-political/files/netherlands_contribution_2_en_0.pdf) accessed 16 February 2017).

<sup>300</sup> ‘We are open to explore further possibilities in the future as long as it is not a fully fledged fiscal union. In the shorter term then, we believe that we should fully utilise all the work that has been carried out.’, Contributions from the Sherpas of the Member States to the Five Presidents’ Report: Malta, First Contribution, 13 March 2015: 3, available at [https://ec.europa.eu/priorities/sites/beta-political/files/malta\\_contribution\\_1\\_en.pdf](https://ec.europa.eu/priorities/sites/beta-political/files/malta_contribution_1_en.pdf) (accessed 11 March 2017).

<sup>301</sup> ‘Malta is a firm believer in the principle of subsidiarity, particularly with regard to the imposition of taxes and the management of tax collection as well as social security and thus we are in principle against any form of additional fiscal capacity for the Euro Area other than that already provided by the EU budget. Malta believes that the positive results brought about by structural reforms should themselves act as an incentive for Member States to carry them out (e.g.: competitiveness goes along with productivity). Malta also believes that the existing instruments developed in the initial stages of the crisis (namely the ESM) together with the ECB’s action as the only pan-European institution to “do whatever it takes” to sustain the Euro are enough to provide the necessary shock-absorption capability that the monetary union requires.’, Contributions from the Sherpas of the Member States to the Five Presidents’ Report: Malta, First Contribution, 15 May 2015: 2, available at [https://ec.europa.eu/priorities/sites/beta-political/files/malta\\_contribution\\_2\\_en.pdf](https://ec.europa.eu/priorities/sites/beta-political/files/malta_contribution_2_en.pdf) (accessed 11 March 2017).



Some member states did not mention fiscal union at all. For instance, France was very brief in its first contribution and did not mention a fiscal capacity as such, but it did say that further solidarity mechanisms, which would go beyond the existing mechanisms like the ESM, would have to be examined.<sup>302</sup> Similarly, Germany provided perhaps the most general and the shortest contribution - in fact, this contribution contains only speaking points and for this reason is not a proper analysis. Even if Germany did not mention a fiscal capacity, so there was no explicit critique of such an idea, it did provide the following statement: 'this Sherpa process should focus (...) on the medium-term perspective of reinforcing EMU architecture, namely through stronger economic policy coordination.'<sup>303</sup> This implies that the German position is to focus only on the policy coordination, which implies continuation of the existing paradigm of fiscal regulation.

The French-German contribution, on the other hand, focused on the medium-term objectives and was quite concrete in recommending the steps that the Commission and the member states should take in this time perspective in order to ensure a well-functioning EMU. Perhaps this is the reason why the possibility of a fiscal capacity was not mentioned in this document. However, at the end, the two countries asserted that changes are needed also in the long term and that they will provide relevant contribution to this discussion by the end of 2016 (they did not).<sup>304</sup> Similar-

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<sup>302</sup> 'La solidarité. La mise en place de différents instruments (Mécanisme Européen de Stabilité, Fonds de résolution bancaire unique, dont la mise en place doit encore être complétée) a permis d'apporter une réponse décisive à la crise des dettes souveraines. L'opportunité de développer d'autres instruments de solidarité au niveau de la zone euro devra être examinée. La mise en place de ces instruments devrait en particulier être articulée avec le processus de convergence des économies.', Contributions from the Sherpas of the Member States to the Five Presidents' Report: France, 26 March 2016: 4, available at [https://ec.europa.eu/priorities/sites/beta-political/files/france\\_contribution\\_1\\_en.pdf](https://ec.europa.eu/priorities/sites/beta-political/files/france_contribution_1_en.pdf) (accessed 17 February 2017).

<sup>303</sup> Contributions from the Sherpas of the Member States to the Five Presidents' Report: Germany, 11 March 2016: 2, available at [https://ec.europa.eu/priorities/sites/beta-political/files/germany\\_contribution\\_1\\_en.pdf](https://ec.europa.eu/priorities/sites/beta-political/files/germany_contribution_1_en.pdf) (accessed 11 March 2017).

<sup>304</sup> '5. Une analyse commune des futurs besoins de la zone euro devra être établie sur la base de la mise en oeuvre de ce programme, afin d'évaluer les étapes supplémentaires qui seraient nécessaires pour garantir durablement la stabilité et la croissance au sein de la zone euro.'

ly, Sweden did not mention fiscal capacity at all, and only noted that any further integration in the EU should be based on analysis and discussion.<sup>305</sup>

To sum up, in this section I listed the arguments of the member states which I labeled 'the negative consequences of fiscalization'. Those arguments are:

- a.) permanent transfers between countries;
- b.) moral hazard.

Importantly, with regard to the negative consequences of fiscalization there are only two substantial arguments. First, that fiscalization would lead to moral hazard, i.e. the member states would intentionally overspend because of assuming that in the case of fiscal troubles, an assistance resulting from the creation of a fiscal capacity would be provided. Second, some countries, notably Finland and the Netherlands, argued that such a solution would lead to the permanent transfers between countries. Those countries feared that fiscalization mechanism would be designed in such a way that the financial flows would always be in one direction, for instance from the North to the South. It is interesting, that the member states did not put forward more arguments against a solution that was long argued for in academia, as shown in Chapter 1.1.

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Elle devrait notamment examiner le cadre politique et institutionnel, les instruments communs et les bases juridiques qui seraient pertinents à plus long-terme. Conscientes de leur responsabilité particulière pour la réussite future de la zone euro et de l'Union européenne dans son ensemble, la France et l'Allemagne apporteront leur contribution à cette analyse d'ici la fin 2016.

Contributions from the Sherpas of the Member States to the Five Presidents' Report: France-Germany, 11 March 2016: 3, available at [https://ec.europa.eu/priorities/sites/beta-political/files/french-german\\_contribution\\_1\\_fr\\_0.pdf](https://ec.europa.eu/priorities/sites/beta-political/files/french-german_contribution_1_fr_0.pdf) (accessed 11 March 2017).

<sup>305</sup> 'Analyze and discuss. Before any far-reaching further steps in integration are considered, thorough discussion and analysis are needed. This is important from a technical, economic and legal point of view, but also with regard to the need for sustained political and democratic legitimacy for the economic governance system.', Contributions from the Sherpas of the Member States to the Five Presidents' Report: Sweden, 17 April 2015: 1, available at [https://ec.europa.eu/priorities/sites/beta-political/files/sweden\\_contribution\\_1\\_en.pdf](https://ec.europa.eu/priorities/sites/beta-political/files/sweden_contribution_1_en.pdf) (accessed 17 February 2017).



Moreover, those two arguments can be seen in the light of six arguments that listed positive effects of fiscalization, in addition to nine preconditions for such a solution. It has to be mentioned, however, that some member states simply stated that fiscalization is unnecessary without providing arguments for such a claim. Even more importantly, the two most important member states - France and Germany, did not mention fiscalization at all and only promised to deliver a common stance on this issue in the future.

## 5.4 Summary

When the EU member states signed the Stability and Growth Pact (SGP) they entered into a path dependency in relation to the EU fiscal governance, from which they cannot escape until today. Perhaps, the EU has to wait for another window of opportunity (Scharpf 2013) in order to develop a substantially different solution, for instance by triggering the process of fiscalization, which would lead to a federal fiscal union. A need for such a European fiscal union has been continually argued for in academia, including economics (see, for instance, de Grauwe 2012) and fiscal federalism theory (Oates 2000). Until now, the aim of the new measures adopted in the aftermath of the Euro crisis, was to make the SGP rules more enforceable, if not automatic.

The EU can exercise power, albeit quite limited in its scope, in spending and borrowing, while taxing, the third element of fiscal power, has been traditionally very limited. The Euro crisis brought about change in the area of borrowing power, whereas EU spending *per se* has not changed, due to the long-term planning of the EU budget. However, even though there is no taxing power as such, the member states of the EU, and of the Euro Area in particular, got engaged in a number of intergovernmental financial vehicles, which can be regarded as the examples of quasi-fiscalization. The European Stability Mechanism (ESM) is the most prominent example of those developments.

As a result, the EU can borrow on the markets, but the EU bonds have a number of unique features. First, they can be used only to lend to the countries 'with the same

coupon, maturity and for the same amount', but the debt itself is nevertheless the obligation of the EU. Second, the EU debt cannot be used to finance EU expenditures. Third, the decisions about the loans are taken by the Council and not by the Commission (the Macro-Financial Assistance is an exception, as in this case the co-decision procedure applies, and thus the Council decides together with the European Parliament). The EU can borrow money on the markets under three financial vehicles: the European Financial Stabilisation Mechanism (EFSM), the Balance of Payments, and the Macro-Financial Assistance. The EFSM has a lending capacity of 60 billion euros and is the largest EU mechanism (84 % of all EU outstanding loans as of 2015). It was used in 2010 to provide financial assistance to two Euro Area countries - Ireland and Portugal.

The ESM, on the contrary, has a different legal basis, it is not an EU mechanism, but an intergovernmental institution. Its role is basically the same as the one of the EFSM - it is to provide credit to countries in financial difficulties. The capacity of the ESM (together with its predecessor, the EFSF) is more than eleven-fold larger than the EU's EFSM - 700 billion euros and has a paid-in capital of 80 billion euros. Remarkably, the budget of the ESM may increase in case a fine is imposed on a Euro Area member state within the Excessive Deficit Procedure (0.2-0.5 % of GDP), according to the Fiscal Compact (in the case a non-Euro Area member state is sanctioned, such a fine would be transferred to the EU budget). Hence, in light of this provision of the Fiscal Compact, the ESM budget may be seen as an equivalent of the EU budget, as the possible sanctions imposed on the Euro Area member states would go to the ESM budget, while sanctions imposed on the non-Euro Area countries would be transferred to the general budget of the EU.

A large number of EU members agreed on a need for the implementation of a fiscal union ('fiscal capacity') in the long term (only Spain opted for a medium term). Three countries, including the most important ones, France and Germany (in addition to Sweden), were silent on the issue. However, it was assured that a common

Franco-German position would be established and delivered by the end of 2016. This promise has not been realized at the time of writing (September 2017). Admittedly, reaching a common position may be difficult as fiscalization of the EU has been quite controversial, and the views of the two countries so far have been quite divergent. France, especially at the time when Emmanuel Macron was the Economy Minister, has long favored the fiscal union with a large European budget, which is a part of the very French idea of *gouvernement économique*. Germany, on the contrary - has favored strict fiscal regulation and opposed fiscalization so far. When in May 2017 Macron became the President of France, the idea of fiscalization, albeit limited to a Euro Area budget financed through current corporate taxes, became the main part of his plans for the reform of the Euro Area and is likely to be the main point of the negotiations on the future of Europe, where Germany is likely to be its main opponent.<sup>306</sup>

Although fiscal regulation was the integration instrument chosen by the EU, the evidence from the contributions of the member states to the Five Presidents' Report, in which the future choices for the EU were outlined, show that it may change in the future. In order to test my hypothesis, as outlined in Chapter 3.2, I analyzed those sources with regard to the prospect of fiscalization. Consequently, I analyzed the arguments, which are summarized in Table 8 below. This allowed me to group the member states in the different categories. In order to avoid cherry-picking of only the evidence which suit my hypothesis, I presented all the arguments relating to fiscalization.

Most countries were repeating similar arguments regarding the idea of a European fiscal union, like a need to avoid moral hazard and permanent transfers between

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<sup>306</sup> 'Macron reiterated his idea that the eurozone should have a common budget, but he didn't ask for much more. And the size of the budget he implied (financed by current corporate taxes) and the timetable (only once they have been harmonized at the eurozone level) suggest a modest, long process.', Politico, " 5 takeaways from Macron's big speech on Europe's future, available at <http://www.politico.eu/article/5-takeaways-from-macrons-big-speech-on-europes-future/>, accessed 27 October 2017.

countries, and to respect existing fiscal rules and budgetary discipline. Three Southern countries were exceptional in this regard - Italy, Spain and Portugal. These member states provided extensive arguments on why a European fiscal capacity is needed. To this end, they offered quite sophisticated ideas in favor of fiscalization. Remarkably, these countries are the debtor states, which can potentially benefit from the introduction of fiscalization. Portugal, for instance, argued that before discussing the revenue side of fiscalization - i.e. how large should the future Euro Area budget be, the focus should be placed on how these funds would be raised and how they would be spent. In reference to the former Portugal argued that funds should be raised through the economic entities with a significant multinational dimension, which benefit the most from the existence of the currency union. In reference to the latter, a clear division of competences between the member states and the Union should be established. Only then one can discuss the expenditure side - how the funds should be spent and how large they should be. This is similar to the arguments in the US, where the Federalists often linked the power to tax to the fact that the new federal government will be responsible for the 'common defense', which was by far the most expensive part of the government spending at that time and would consequently free the member states from that burden.

Most member states agreed that such a far-reaching solution as fiscalization should be considered only in the long term and first of all the existing measures should be fully implemented. These measures concern mainly fiscal rules and respecting them, once fiscalization is introduced, would be a guarantee against moral hazard. Other measures, however, concern quasi-fiscalization, as I call it - mainly the ESM, and some contributions (such as Italy, Spain, and Portugal) argued that the ESM should be transformed into something akin to the International Monetary Fund. The use of the funds of a European Monetary Fund, as it was named, should be considered as a normal part of the functioning in the monetary union, and not just as an element of 'assistance programmes', which carries negative connotations.

Therefore, the use of these funds should not further deteriorate the economic and fiscal position of a member state in need of the financial assistance, as is currently the case with the ESM.

The fact that many contributions supported the idea of the Euro Area fiscalization, due to its potential to accommodate asymmetric economic shocks further supports my claim that fiscalization is likely to occur as a result of a threat. It is because such shocks are the form of the economic internal threats. Interestingly, many non-Euro Area members had a strong opinion on this subject, even if such fiscalization would not include them. This is true not only for the countries like Poland or the Czech Republic, but also for those who have a formal opt out from joining the Euro Area, such as Denmark.

The non-Euro Area member states were quite united in their opinion that any further fiscal integration in the Euro Area should not undermine the single market and should respect the rights of all EU member states. Notably, they also highlighted the fact that a well-functioning EMU is in the interest of all EU 28. All in all, the non-Euro Area members were usually of the position that it would be up to the members of the Euro Area to decide if they want to go ahead with such a measure as fiscalization. Curiously, virtually none of the member states raised an idea of fiscalization for the EU as such - it was rather clear that such a solution, if chosen, would be limited to the Euro Area.

At the same time, by reading these contributions, one may raise a question if all the member states understood what a fiscal capacity means exactly and if the Commission and the member states understood this concept in the same way. For instance for Latvia, the Commission's flexibility of application of the fiscal rules 'already

demonstrate EU and Euro Area level fiscal capacities'<sup>307</sup>, which confuses regulation with capacity (or fiscalization for that matter). This is the evidence of the need to define the most important concepts, such as fiscal union or fiscal capacity, in the EU documents, in order to avoid a conceptual chaos and misunderstandings. The concept proposed by this dissertation - fiscalization - might be a good starting point for such conceptual clarification.

**Table 8. The main arguments concerning the fiscalization of the EU.**

Type of arguments	Arguments
<b>1. Preconditions for Fiscalization</b>	a.) a better national budget surveillance enforcement
	b.) sound fiscal policies
	c.) a link to structural reforms
	d.) respecting integrity of the single market and rights of non-Euro Area member states
	e.) a gradual process
	f.) respect for tax autonomy of the member states
	g.) a limit on tax autonomy of the member states
	h.) a clearly assigned division of competences between the

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<sup>307</sup> Contributions from the Sherpas of the Member States to the Five Presidents' Report: Latvia, Second Contribution: 2, available at [https://ec.europa.eu/priorities/sites/beta-political/files/latvia\\_contribution\\_1\\_en.pdf](https://ec.europa.eu/priorities/sites/beta-political/files/latvia_contribution_1_en.pdf) (accessed 17 February 2017).

	member states and the EU
<b>2. The Positive Consequences of Fiscalization</b>	a.) an investment tool for the creation of European public goods
	b.) a stabilization mechanism to accommodate asymmetric shocks
	c.) democratic legitimacy and political union
	d.) 'a favourable economic climate' and convergence
	e.) a link to own resources
	f.) the use of the European Stability Mechanism
<b>3. The Negative Consequences of Fiscalization</b>	a.) permanent transfers between countries
	b.) moral hazard

Source: Own Illustration.

Admittedly, many contributions did not mention a threat - the main factor underpinning my hypothesis. However, this is the very reason, I argue, why there is no fiscalization in the EU - the threat emerging from the Euro crisis was not perceived by the member states as large enough to trigger such a fundamental shift in the instruments of integration. As a result, fiscal regulation, and not fiscalization, was chosen.

Despite choosing the apparently less intrusive instrument of fiscal integration, the member states ended up giving up a lot of their ability to conduct autonomous fis-



cal and macro-economic policies. True, regulation implies that there is no moral hazard and no transfer union, which were the two main arguments of the opponents of fiscalization, as demonstrated in Chapter 5.3.3. But fiscal regulation is not without problems. By analyzing the new economic governance of the EU, mainly in the form of the European Semester, an annual cycle of fiscal and economic surveillance, I demonstrated that the EU has created an extremely complex framework, which has five quite problematic issues. First, an accountability deficit has been created. The enlargement of the powers of the Commission was not accompanied by the extensions of the structure of accountability. Moreover, such powers may affect the existing accountability relationships at the national level. For instance the requirement for the Euro Area member states to send the drafts of their annual budgets for the consultation with the Commission in November leaves only one month for the national parliaments to assess these drafts. As a result, an accountability challenge has been created for the EU institutions involved in the economic decision-making (Dawson 2015).

Second, the sanctions under the Excessive Deficit Procedure can be imposed by the decision of a minority of the Council (on the recommendation of the Commission). Such a solution, the so-called 'reverse qualified majority voting' may be justified because - by making the fiscal rules more enforceable - it increases the credibility of these new rules. However, it raises concerns with regard to the basic democratic principles of a majoritarian voting (see, for instance, Crum 2013). Third, the new economic governance concerns not only debt, but also macro-economic policies of the member states, as the EU can now recommend actions to be taken in virtually all policy areas, including taxation, pensions and healthcare.

Fourth, a large 'discretion space' for the Commission was created. While 'intelligent' implementation of the rules, as mentioned by the Commissioner Pierre Moscovici when the Commission was deciding whether to sanction Spain and Portugal for breaching the deficit threshold, means that the Commission is free to decide auton-

omously whether or not a country breaks a rule. It is because it can take into account 'all relevant factors' affecting the economy of a given country. This corresponds to the first point - that is - a lack of accountability on the part of the Commission. How can the Commission be held accountable while taking decisions that affect the lives of millions of Europeans? As mentioned in the third point, the EU can now recommend actions in the macroeconomic policies of the governments. How the citizens can challenge those decision? What if a sanction imposed on a given country is unjust? In the case of Spain a fine of 0.2 % of its GDP would amount to 2 billion euros, not a small sum for any country. This brings me to the fifth problematic issue: how much choice is left for the democratically elected governments if so many of their policies can be challenged by the EU? It goes beyond the scope of this dissertation to answer those questions and a further research is needed in order to do so. Nevertheless, it may be easier to find an answer to some of those issues if one confronts this European experience of fiscal integration with the American one. I elaborated extensively on the rationale of the US-EU comparison in Chapter 3.1 devoted to case selection and here I will only recapitulate its main points.

A number of scholars have compared the EU and the US (e.g. Fabbrini 2007; for a survey of this literature see Tortola 2014) and this literature is sometimes labeled 'the lessons for Europe' type of research. The rationale of this type of comparison lies in the fact that both the EU and US went through quite similar process of 'coming together' (Stepan 1999) and in the fact that those two polities are compared at the same time of the development of their respective Unions. For instance, Kelemen (2013) does exactly this - he compares the EU and the US at the same stages of their 'federal' development. He shows that in the early, formative years the US federal government was quite weak, and in many areas of the 'core state powers', including taxation, the US early republic resembled the modern EU. Following this rationale, I compare the two polities when their fiscal structures were similar, as identified by

Sargent (2012) who in his Nobel Prize lecture titled 'United States Then, Europe Now' compared the modern EU with the US in exactly the same timeframe as I do in this dissertation, i.e. the US under the Articles of Confederation.

Comparing these two polities does not imply that one regards the EU as a federation, nor that the EU should follow the same path of its development as the US did. Such a comparison only means, as Burgess (2009: 30) reminds us, that 'integration' is quite similar to the coming together of states units that were previously independent, just like in the case of the US. Hence, in order to demonstrate the differences, but also crucial similarities between these two polities, in the following chapter I compare both the instruments of their fiscal integration (fiscal regulation and fiscalization) as well as the arguments that were used in favor and against fiscalization.

## 6 Comparative analysis

*(...) the classic fiscal federalism model seems revolutionary at first, but may arguably protect national autonomy more effectively by guaranteeing that Member States maintain discretion to decide how to raise their revenues and how to allocate and spend them, and by limiting the level of detail at which surveillance and direction from the centre can take place. Since the [European] Union would raise its own revenues, it would [be] able to address structural inequalities and asymmetric shocks by making use of its own macroeconomic and fiscal tools.*

Alice Hinarejos<sup>308</sup>

### 6.1 Introduction

In analyzing the US and the EU I drew on Riker's theory of threats, as described in Chapter 2.2, in order to explain how fiscalization emerges. In order to answer this research question I have further developed Riker's theory and consequently I argued

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<sup>308</sup> 'Fiscal Federalism in the European Union: Evolution and Future Choices for EMU', In *Common Market Law Review* 50: 2013: 1640-1641.

that an endogenous threat was the single most important reason for the emergence of fiscalization. The empirical evidence shows that indeed that was the case in the US and partly in the EU, where a process which I call quasi-fiscalization has been started. However, the EU decided to react to a threat of the Euro crisis by enhancing its capacity of regulation of the fiscal policies of the member states, which is a very different approach from the one taken by the US. This chapter sets out to compare those different mechanisms of fiscal integration as used in the US and the EU.

The debt crisis triggered power migration to the central (federal/supranational) level of government in the area of fiscal policy in both the EU and the US, albeit of a different kind. Whereas the EU mainly witnessed the enhancement of its fiscal regulatory power (fiscalization attempts had a limited success, as I demonstrated in Chapter 5.2), the US opted for fiscalization - the creation of a fiscal capacity at the federal level in the form of the power to tax. Therefore this similarity, the transfer of power to the center, and this difference, a different kind of such a transfer, are perhaps the most important findings of this comparative study.

Consequently, the US and the EU are examples of fiscalization and fiscal regulation, respectively. One should note, however, that fiscal relations in federation-like polities are complex and not all policies relating to taxation, spending and borrowing fit the categories described above. This is especially true for the EU, which has created an extremely complex hybrid of regulation, on the one hand, and quasi-fiscalization, on the other. Indeed, as I demonstrate further down in this chapter, just as the US was involved in quasi-regulation before the debt crisis, the EU engaged in quasi-fiscalization during the post-crisis period. Table 9 below summarizes these findings.

**Table 9. Fiscalization and the fiscal regulation in the US and the EU**

Period	US	EU
Pre - threat (sovereign debt crisis)	Quasi regulation	Weak regulation
Post - threat	Strong fiscalization	Strong regulation + Quasi fiscalization

Source: Own Illustration.

I will now turn to the question of similarities between the early US and the EU. Subsequently, there are two crucial similarities between the current EU and the US under the Articles of Confederation: the lack of the federal power to tax and a sovereign debt crisis of their respective member states. In both polities the latter was (partially) the result of the former. Clearly, the lack of such a power to tax, and therefore of a significant central budget, contributed to the debt crisis of the US states, which had to pay for all military spending during the War of Independence. As a result, they took out large loans, which had to be paid back by imposing high taxes in the after-war period. Similarly, some of the EU member states experienced debt crisis in the 2010s. The type of crisis, therefore, was quite similar in both polities. However, one important difference was the source of this sovereign debt crisis. While in the US there was a common cause - the War of Independence; in the EU the fiscal policies of the member states were clearly the main causes of the debt crisis. This difference may make it more difficult for the EU member states to agree on fiscalization of the EU.

The sovereign debt crises in the states triggered important changes in fiscal policies

in both the US in 1780s and the EU in 2010s. The policy responses in two polities, however, were quite different. Whereas in the US this crisis triggered a fiscalization process, which resulted in the creation of the federal power to tax, the EU member states decided not to build supranational fiscal capacity, but to create a hybrid structure which consists mainly of enhanced regulation of member states' fiscal policies (the Six Pack, the Two Pack, the Fiscal Compact) and quasi-fiscalization - in the form of international (ESM) and supranational (EFSM) financial institutions.

Another important difference is the fact that the US and the EU followed a completely different path of creating an economic union. The US chose to create a federal fiscal union first, and only then a fully-fledged monetary union. By contrast, the EU first created a monetary union, and recently made only attempts at creating a fiscal union, which is still quite a distant project. In the following section I will analyze the similarities and differences between the instruments of fiscal integration of the US and the EU.

## 6.2 Fiscalization and regulation in the US and the EU

### *6.2.1 The regulation of fiscal policies of the member states in the US and the EU*

When the EMU was designed in Maastricht, it was decided that the creation of a monetary union would not be accompanied by the subsequent creation of a federal fiscal union. Thus, fiscalization of the EU was ruled out at that point. The result was that the common monetary policy was accompanied by a number of fiscal policies - different in every member state. In order to prevent the negative spillovers resulting from the fiscal policies of some countries, it was decided that these policies would be coordinated. As a consequence, from the two available policy paradigms - fiscal regulation and fiscalization of the EU, the former was chosen. The sovereign debt crisis in the Euro Area member states, however, changed those dynamics and triggered modifications in the way the EMU is governed. In principle, the EU followed the old paradigm of regulation, which was significantly strengthened, but some form of fiscalization, albeit limited and mainly controlled by the member states, was also created.

This regulation of the fiscal policies of the member states mainly took the form of enhancing deficit and debt criteria of the Stability and Growth Pact. But the surveillance mechanisms of the EU went beyond solely guarding the level of indebtedness - the macroeconomic policies of the member states are now also a subject of EU moni-



toring. These new rules emerged mainly in three sets of legislation called the Six Pack, the Two Pack, and the Fiscal Compact. The Six Pack consists of six documents - three regulations and one directive concerning fiscal policy and two regulations regarding macroeconomic policies. The most important part of the Six Pack is the European Semester, which is a name of the EU's 'annual cycle of economic policy guidance and surveillance' and includes all the mechanisms that the EU exercises over the fiscal, and economic policies of its member states. Within the Semester, the documents that are presented by the member states to the Commission, as well as the Commission's recommendations, have a specific timeframe, including deadlines. The majority of the Six Pack legislation applies to all EU member states (with the exception for the two regulations targeting only the Euro Area countries), while the Two Pack applies only to the Euro Area, and the Fiscal Compact - to all EU members, but the UK, the Czech Republic and Croatia.

Both the Six Pack and the Two Pack are part of EU law (secondary law), while the Fiscal Compact is an intergovernmental treaty and as such is not part of the EU legal architecture. Consequently, the new fiscal rules are quite differentiated. For instance, there are two important provisions that apply only to the members of the currency union. First, the Euro Area members can face sanctions for not implementing the recommendations of the Commission, ranging from 0.1 % to 0.5 % of their GDP. Once recommended by the Commission, the sanctions are a default option for the Council, which needs a qualified majority to overcome them. Second, the governments of the Euro Area countries must submit their draft annual budgets (in addition to the three years economic plans, as the rest of the member states) for the Commission's consultation already in November, even before they are sent to the national parliaments.

As a result of the Six Pack legislation, any EU member state can be a subject of the two 'Procedures': the Excessive Deficit Procedure (EDP) and the Macroeconomic Im-

balance Procedure (MIP)<sup>309</sup>. The former can be activated if the deficit level goes beyond 3% of GDP. Furthermore, it was enhanced by including a debt criterion. As a result, the EDP can be activated also based on the level of debt, and not just deficit, contrary to what its name may suggest. The latter procedure, the MIP, which was introduced in 2011, can be activated if the Commission finds that a country has a macroeconomic 'imbalance'. It does so by analyzing the economic conditions of each country, based on a special scoreboard of fourteen economic and social indicators. If such imbalances are 'excessive', the Commission may trigger the Excessive Imbalance Procedure (EIP). However, so far such a drastic measure has not been implemented, due to the fact that either the countries identified with the imbalances took appropriate action to correct them, or they were under 'programmes of financial assistance', and as such - excepted from the MIP or the EIP, as they were already closely monitored within their programmes (most notably - Greece). As the result of the above-mentioned legislation the Stability and Growth Pact was strengthened, both its preventive arm, which aims at detecting deficits before they occur and the corrective arm, which aims at correcting existing deficits and debts. The economic plans of the member states, the so-called Stability/Convergence Programmes, are part of the former arm, whereas Excessive Deficit Procedure is the main component of the latter.

The European Semester, the main element of the new EU fiscal and economic governance, kicks off in November, when the Commission presents its economic priorities for the next year, the so-called Annual Growth Survey. These priorities are then embedded in the Country Specific Recommendations (CSRs), which are published six months later - in May, and conclude the European Semester. In the CSRs advice is given to the member states for the next 12-18 months on 'how to boost jobs and growth, while maintaining sound public finances' - admittedly, a challenging task. These recommendations are the result of the dialogue with the member states that

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<sup>309</sup> The MIP can lead to the Excessive Imbalance Procedure (EIP).

last for six months, and are meant to reflect both the priorities of the EU as a whole (as laid out in the Annual Growth Survey from November, Country Reports from February, where the economic performance of every state is assessed, and economic forecast from May), as well as the priorities of the member states, as outlined in the following documents - National Reform Programmes and Stability Programmes (for the non-Euro Area countries these are called Convergence Programmes, the difference is that plans concerning monetary policy must also be included) from April. Stability Programmes are especially important, as they are documents in which governments present their plans for economic and fiscal measures. Significantly, all the EU member states must submit these economic plans in April.

When the threat resulting from the debt crisis was the largest, the EU was eager on creating a fiscal union in the long term, a fiscal capacity, as it is called in its official documents. Consequently, in 2012, both the Council (2012) and the Commission (2012) issued reports, where they called for such a solution to be implemented in order to 'complete EMU'. However, when the threat of the Euro Area breakup diminished in the following years, mainly due to the actions of the ECB (starting with the famous words in the summer of 2012 of Mario Draghi, its President, who said that he will do 'whatever it takes' to save the euro), the appetite for a paradigm change in the fiscal governance of the EMU evaporated to a large extent. As a result, in the Five Presidents' Report of 2015, a strategic document outlining the options for the future of the EMU, there is no mention of a fiscal capacity, albeit there is a section called 'Fiscal Union'. In this context, we can again see the ambiguity of this concept and how many meanings it carries for different authors. In this report, 'fiscal union' is treated as an extension of the fiscal regulation of the EU (it calls for the creation of the Fiscal Boards overlooking the budgets of the member states), and not as EU fiscal capacity, or EU fiscalization, to use the concept of this dissertation, as outlined in Chapter 2.3. When the threat diminished, the chances of fiscalization did so, too. However, the election of Emmanuel Macron as the President of France may change this, as he put

fiscalization of the EU as one of his top political priorities (see, for instance, his 'Sorbonne speech' from September 2017).

In the US, on the other hand, a threat resulting from the debt crisis created a window of opportunity that the elites of the new Union captured quickly. Within less than a year since the outbreak of the Shays's Rebellion - the most serious tax protest - which was a result of the debt crisis and state tax policies, the new Constitution was drafted. The American elites used this window of opportunity to present a completely new document, with the federal power to tax, even if the mandate of the Philadelphia Convention was only to revise the existing constitution, the Articles of Confederation. Indeed, it was a revolutionary act and was sometimes called 'a revolution in favor of government' (for instance it is a title of a history book on this period [Edling 2003]). So far, there was no such an equivalent in Europe - no 'revolution in favor of the EU'.

The policies of the US Confederation under the Articles of Confederation in the fiscal domain can be viewed as fiscal regulation, as they had an enormous effect on the fiscal policies of the states. Admittedly, it was quite a different kind of regulation than the one in the EU, and for this reason I call it quasi-regulation, as shown in Table 9. Prior to the debt crisis both the US and the EU were engaged in regulating fiscal policies of their states, albeit in different forms and to different degrees. The EU mainly regulated the level of deficits, which was not the case in the US. The US Confederation affected the budgets of the states in two ways. First, by asking for enormous financial contributions and - second - by borrowing on the credit of the states. As a result, the US states had to tax heavily in order to pay off both their own, as well as the national debt.

What is similar between the US and the EU is that both polities made the attempts for fiscalization within existing constitutional frameworks. In the case of the US it

took the form of two proposals for the federal power over impost (a form of tariff) in 1780s. Both attempts failed, because of the veto of one single state, Rhode Island and then New York. In the EU, these attempts took a different form - not as a formal proposal of legislation, but in the blueprints and reports of the Commission (2012) and the Council (2012), at the time when the endogenous threat resulting from the sovereign debt crisis was the greatest. These attempts were made at the height of the Euro crisis and subsequently diminished as the crisis passed its most acute phase.

Whereas in the EU the debt to a large extent was driven by the fiscal policies of the member states, in the US the cause was rooted in the common endeavor - the War of Independence and was a consequence of the lack of central defense budget. Thus, the causes of the sovereign debt crisis in the US in 1780s and the EU in the 2010s were different and it may be a main obstacle for the creation of a European fiscal union. To conclude - both the EU and the US regulated the budgets of their member states, but the means of doing so were quite different. Moreover, both polities made attempts for fiscalization, albeit with different degrees of success, a topic I turn to in the next section.

### ***6.2.2 Fiscalization in the US and the EU***

In Chapter 4 I argued that the Shays's Rebellion was perceived as an internal threat to the Union, and as such it helped the Constitution to emerge. The federal tax power was one of its most important features. Furthermore, the Constitution helped to ensure that American people stay loyal to the Union. It was done through granting the federal government the power to tax, which ultimately brought about a decrease in an overall tax burden. Paradoxically, in order to tax less, the states needed to give up some of their tax powers, such as the power to tax imports. These taxes, the custom duties (impost/tariff) could be only effectively levied at the federal level, because the tax competition between states would otherwise ensue. As a result, the states would keep lowering the rates and a classical 'race to the bottom' would emerge. To be sure, for some states it was easier to accept such a pooling of the tax power than for the others, and the main reason for this divergence were the differences in their geographies and economies.

Unsurprisingly, the coastal states with large, vibrant ports and trade as a significant part of their economies, such as Rhode Island or New York, were against such a transfer of tax powers, because their own budgets relied heavily on the custom duties, the anticipated federal tax. Other states, with no such ports and economies mainly based on agriculture, rather than trade, were generally in favor of this federal power to tax. Part of the reason was that these agricultural states had to pay their share of the custom duties imposed by the trading states, like New York, without benefiting from this income. It was due to the fact that agricultural states were also buying imported goods from the merchants, who included the coastal states' taxes in the price of these goods. As a matter of fact, the states which opposed the most the

federal power to tax were also the most prominent opponents of the Constitution - for instance Rhode Island ratified it only when the first Congress was already in session, and New York as a ninth one and the last one of the big four (after Pennsylvania, Massachusetts and Virginia).

In the EU, on the other hand, one can observe a process of quasi-fiscalization. For instance, as a result of the Euro crisis, the EU has utilized its borrowing power. Consequently, a special lending mechanism (EFSM) was created, which allowed the EU to issue bonds on the capital markets with the EU budget as a collateral. This debt, however, cannot be used to finance the EU deficit, but only to lend to the member states in severe financial difficulties. By doing this, the EU in a way lent its credit rating to those member states, and consequently made the costs of borrowing cheaper. Importantly, this mechanism was created by using art. 122 of the TFEU, which states that financial assistance may be provided to countries, which experience a natural disaster or other events 'beyond [their] control'. It can be contested if the economic crises of Portugal and Ireland, the countries that used financial assistance from the EFSM were beyond their control. Nevertheless, this is evidence confirming my hypothesis, as outlined in Chapter 2.3, that fiscalization, or quasi-fiscalization for that matter, emerges as result of a threat. Furthermore, the ESM - another lending institution - is in principle very similar to the previous mechanism (EFSM). However, the ESM, as opposed to the EFSM, is outside the EU law and is a permanent institution with a lending capacity eleven-fold larger than the EFSM. Still, its creation confirms my hypothesis that the Euro crisis was regarded as a threat (albeit, not large enough to trigger a full-fledged fiscalization of the EU).

A comparison with the US gives a hint of the direction in which the developments of this process could potentially lead. The debt of the US federal government was of quite similar nature. It partly grew out of the assumption of the states' debt. This kind of bail-out is forbidden by the EU treaties, but as I showed in this dissertation, the mechanisms developed in the EU, which allow for lending to its member states,

resemble the nascent US federation. While the Commission did not assume an excessive debt, like the US government did, the final result is similar: a central government has an authority to issue bonds. As Pisani-Ferry (2012:4) notices: 'An intriguing feature of US history is therefore that the competences and features of federal government grew out of its assumption of state debt'. However, as I demonstrated in Chapter 4.3, the competences of the federal government were provided in the Constitution of September 1787, and at that time there was no evidence that this new federal government would assume the debt of the states. For this reasons Virginians were so surprised when Hamilton presented his plan. Virginia, an American equivalent of Germany in the EU, already paid off the majority of its debt. Still, its consent for the assumption plan had to be negotiated. As a result of this bargain the seat of the federal government, known as District of Columbia, was located at the border of Virginia.

Nonetheless, it is true that the assumption gave a further justification on the concrete tax bills. Once the debt was acquired, the federation looked for the means of financing this debt. While the mechanisms developed by the EU are admittedly far from either fiscalization or assumption of the member states' debt, it is true that a potential default of a given state (e.g. on the loans from the ESFM) would result in the losses that ultimately the EU, and rather - its member states, would have to bear.

Notwithstanding the salience of comparing the actual fiscal mechanisms that were developed in both polities, it is also relevant to compare the arguments that led to either fiscalization, as was the case in the US, or the attempts for such a solution, as observed in the EU. This is the topic I examine in the following section.



## 6.3 The arguments regarding fiscalization in the EU and the US

When the Euro crisis out broke in 2010, there was an agreement among EU political elites on the need to strengthen the governance of the EU, and it was also generally agreed that there were two ways of doing this – either by regulating the fiscal policies of the EU member states or by creating a fiscal union, with EU tax and borrowing power, akin to that of the US Treasury. Such a fiscal union would lead to the EU with a much larger, independent budget and which therefore be able to conduct fiscal policy on its own in order to help countries experiencing economic depression. Germany, favoring regulation, and France, supporting fiscal capacity, are advocates of these fundamentally different approaches. So far, the German approach to fiscal regulation has prevailed - EU fiscal rules were tightened, while an EU treasury, or the French idea of *gouvernement économique*, was not implemented. However, there was an extensive debate in the EU on the prospect of such fiscalization. Importantly, there is an access to a unique set of sources: the positions of every member state (but Greece) regarding the prospect of fiscalization of the EU, which were provided as part of this debate, which led to drafting a strategic document outlying the future options for the EMU.

This document is called the Five Presidents' Report, named after its authors, the five presidents of the EU institutions, and can be regarded as a European equivalent, albeit much less comprehensive and definitely less ambitious, of *The Federalist* papers. It puts forward potential future developments of the Union in three timeframe perspectives - the short, the medium and the long term. Unlike the US, the EU did not

go through a comprehensive debate about its future, where the arguments from both sides - the proponents and the opponents of granting the EU institutions more powers - would be presented. However, this may change as French President Macron plans to organize in 2018 citizen conventions to debate the future of the EU.<sup>310</sup> Moreover, in the EU case we do not have access to the minutes of the crucial meetings where these issues could be discussed. However, we do have access to the preferences of the member states regarding the prospects of EU fiscalization. In the US, on the other hand, documents from federal constitutional and states' ratification conventions are available, in addition to a vast amount of the newspaper articles, such as *The Federalist* or the pamphlets written by the Anti-Federalists, such as Brutus, A Son of Liberty or Federal Farmer. I examined these documents in Chapter 4.3 and 5.3. I will now turn to the similarities and differences of the American and the European arguments concerning fiscalization.

The arguments concerning fiscalization are summarized in Table 10 below and are divided into three groups: the negative consequences of the contribution system (for the EU - preconditions for fiscalization); the positive consequences of fiscalization (in the US called the power to tax of the federal government, while in the EU - either fiscal capacity or a fiscal union); and the negative consequences thereof.

There are four main differences between the arguments used by the US states and the EU countries. First, the Americans, unlike the Europeans, discussed a written proposal - the text of the Constitution, and so could favor or oppose its specific clauses. This allowed for a proper debate, as proponents and opponents of the federal power to tax clause were engaged in a discussion in which both sides knew exactly what is debated. In the EU, on the contrary, the member states were asked to provide their opinions on fiscalization, but then it was up to the Presidents of the EU institutions to draft their report and pick up the opinions they preferred.

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<sup>310</sup> 'Macron to 'rebuild' EU with citizen conventions', available at <https://euobserver.com/political/138941>, (accessed on 9 September 2017).

Table 10. The main arguments concerning the federal power to tax in the US and the EU

Type of arguments	The arguments	
<b>1. The Negative Consequences of the Contribution System (for the EU - preconditions for fiscalization)</b>	<b>US</b>	<b>EU</b>
	1.1. Plunder of the people and 'atrophy' of the Union, followed by its dissolution;	a.) a better national budget surveillance enforcement;
	1.2. States constantly negotiate the level of their contributions;	b.) sound fiscal policies;
	1.3. The coercion of states to comply with fiscal directives (which is madness and leads to a civil war).	c.) a link to structural reforms;
		d.) respecting integrity of the single market and rights of the non-Euro Area member states;
		e.) a gradual process;
		f.) respect for tax autonomy of the member states;
		g.) a limit on tax autonomy of the member states;
		h.) a clearly assigned division of competences between the member states and the EU.

<b>2. The Positive Consequences of Fiscalization</b>	2.1. Federal credit and the ability to borrow at low rates;	a.) an investment tool for the creation of European public goods;
	2.2. A possibility to tackle future unpredictable exigencies: A Constitution written for centuries, not decades;	b.) a stabilization mechanism to accommodate asymmetric shocks;
	2.3. States will contribute equally based on their wealth, and not on a direct exposure to a threat;	c.) democratic legitimacy and political union;
	2.4. Federal responsibilities will be matched with federal resources;	d.) 'a favourable economic climate' and convergence;
	2.5. The unlimited federal power to tax will paradoxically lead to lower tax rates;	e.) a link to own resources;
	2.6. Unlimited power within a limited sphere;	f.) the use of the European Stability Mechanism.
	2.7. The federal government will be able to act directly on citizens;	
	2.8. The fiscal needs of the states will diminish, as some of their responsibilities will be shifted to the federal level;	
	2.9. Federal taxes will have a natural limit against excess.	

	2.10 Fiscalization will lead to a more democratic government.	
<b>3. The Negative Consequences of Fiscalization</b>	3.1. The states would be left with no money, since federal government would collect all the taxes	a.) permanent transfers between countries;
	3.2. The federal government would use the money to oppress the people and repress their liberties;	b.) moral hazard.
	3.3. The 'supreme law of the land' and the 'proper and necessary' clauses give unlimited power to the federal government;	
	3.4. The expansion of the federal tax administration;	
	3.5. The increase of the overall burden of taxation;	
	3.6. It is against the principle of 'no taxation without representation': 'the people will be taxed without their consent, as a large part of the population will not be represented in the federal Congress.'	

Source: Own Illustration.

In fact, in the report there is no mention of a fiscal capacity as such, even though nine

member states favored this solution in a medium to long term (Spain, Italy, Austria, Belgium, Bulgaria, Poland, the UK, Luxembourg and Portugal), and eleven states, although skeptical of this solution, were nevertheless willing to consider it (those include Cyprus, the Czech Republic, Denmark, Estonia, Hungary, Ireland, Lithuania, Latvia, Slovenia, Slovakia and Romania). Significantly, only three member states were against fiscalization *expressis verbis* (Finland, Netherlands and Malta), and France and Germany (in addition to Sweden) did not provide their preferences. Nonetheless, and regardless of the fact that the majority was either in favor or willing to consider such option, fiscalization did not end up in the text of the Report. This raises a question of transparency in drafting such important documents, especially with regards to the option that is chosen to be included in the final draft, which sometimes can be against the preferences of the majority of the member states.

This leads me to a second difference. The Framers of the US Constitution focused not only on the short or medium term, but on the long term, too. They understood that the document that they were drafting is to serve the US for centuries ('we must bear in mind that we are not to confine our view to the present period, but to look forward to remote futurity' [*Federalist* 34: PAH IV: 471]), and for this reason a power to tax that is given to the federal government could not be limited to its current needs: 'There ought to be a CAPACITY to provide for future contingencies as they may happen; and as these are illimitable in their nature, it is impossible safely to limit that capacity' (*Federalist* 34: PAH IV: 472). By doing this, the Framers linked a particularity of financing the Union with a more general nature of the document they were drafting.<sup>311</sup> In the EU, the time horizon was rather short as many mechanisms created during the Euro crisis were temporary, and when some of those mechanisms were transformed into the permanent ones, like the European Stability Mechanism, their

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<sup>311</sup> 'Constitutions of civil government are not to be framed upon a calculation of existing exigencies, but upon a combination of these with the probable exigencies of ages, according to the natural and tried course of human affairs.' *Federalist* 34, PAH IV: 471.

institutional design lacked the capacities needed to address the flaws of the Euro Area institutional architecture.

Third, in contrast to the US, the European countries did not criticize the current system of financing the EU budget *per se*. Instead, they provided preconditions for fiscalization, such as better national budget surveillance enforcement or a clearly assigned division of competences between the member states and the EU. The indicated measures to be taken before progressing towards fiscalization were sometimes contradictory, like tax autonomy of the member states, as some countries, such as Spain, preferred to limit, while others, such as Ireland - to respect it. Yet another precondition was to respect integrity of the single market and the rights of non-Euro Area member states. This leads to the fourth difference - the majority of the EU contributions centered on the need of fiscalization of the Euro Area, and not the EU as a whole. If chosen, this would constitute a further differentiation of the fiscal integration of the EU, which was not the case in the US.

Apart from these differences, there are some similarities within each group of arguments that can be observed. In both cases we observe the negative, as well as the positive consequences of fiscalization. Moreover, within these two groups we can enumerate analogous arguments.

When it comes to the positive consequences of fiscalization there are three main similarities. First, fiscalization would create a central budget, which would provide means to tackle both the current and the future threats, 'exigencies' as Americans called them, or 'asymmetric shocks', as the Europeans did. Moreover, such a budget would create the common public goods that all the member states would benefit from. Second, the argument that fiscalization may trigger a further democratization of central institutions was used in both cases. In both the US and the EU it was clear that fiscalization could not be granted without further changes in the structure of

central institutions, which would have to become more democratic and more accountable. In the US case, it was done by creating a system of checks and balances within the federal government, with three branches - the bicameral Congress, the President and the Supreme Court. Similarly, in the EU - the idea of enhancing democratic legitimacy through the creation of a political union was raised. Third, fiscalization - the power to raise revenues from own resources as defined in this thesis - in the US is called simply federal tax, while in the EU it is referred to as 'fiscal union' or 'fiscal capacity'.

Significantly, it is not always clear what do the EU member states refer to when they use those two concepts of *fiscal union* and *fiscal capacity*: an enlarged budget still based on the contributions from the member states? A budget of the same size, but based on 'own resources'? Or perhaps fiscalization - a full-fledged federal fiscal union with the EU tax power? In order to avoid confusion and misunderstanding, the concepts used by the member states and the EU institutions should be clearly defined. Chapter 2.3 of this dissertation proposes such a clarification.

With regard to the negative consequences of fiscalization, the main difference is perhaps the number of arguments, as the EU member states presented only two - that a fiscal capacity would lead to permanent transfers between countries and that it would create moral hazard. In the US, on the other hand, there were six arguments that the Anti-Federalists used to combat the idea of fiscalization of the federal government - these centered on the possible infringement of the rights of both the states and the people. For instance, they claimed that the states would be left with no money, as the federal government would collect all the taxes. The federal government would be able to do this, so the argument went, because of the 'supreme law of the land' and the 'proper and necessary' clauses of the Constitution. As a result, it was argued that the overall tax burden would increase and the federation would use the new power to tax to oppress the liberties of the people.



This dissertation has demonstrated that an endogenous threat was the main factor leading to fiscalization in both polities under investigation. In the US, for instance, it was argued that if the current requisition system is maintained, the plunder of the people and the 'atrophy' and dissolution of the Union will follow, as shown in Chapter 4.3. The other two arguments used in America are quite relevant for the debate in the EU. First of all, it was argued that the states would constantly negotiate the level of their contributions and that the coercion of the states to comply with the fiscal directives is madness. Interestingly, such bargaining is a feature of the EU's budgetary framework - the Multiannual Financial Framework, which is negotiated every seven years. The second argument stated that the coercion of states to comply with the fiscal directives would never be confined to a single state, and may even lead to a civil war. The EU, as shown in Chapter 5, acquired a good deal of power over fiscal and economic policies of the member states, to the point that it can impose a fine up to 0.5 % of GDP if a member state does not comply with the Commission's recommendations (as part of the Excessive Deficit and Excessive [Macroeconomic] Imbalance Procedures). Importantly, the sanctions can be imposed based not only on the deficit and debt criteria, but also for failing to take a corrective action in addressing macroeconomic imbalances.

In the EU, the boldest proposals for fiscalization were presented in 2012, at the peak of the Euro crisis, but the appetite for the reform of the way the EU (and the Euro Area) is financed diminished in the following years. In the arguments presented by the member states in 2015 however, a number of positive consequences that fiscalization could bring was outlined, such as an investment tool for the creation of European public goods. These arguments were advanced mainly by the Southern debtor states, such as Italy, Portugal and Spain.

Hence, a very few countries were explicitly against fiscalization. Interestingly, those which did, such as the Netherlands and Finland, are the major Northern creditor countries. Instead, most of the member states outlined detailed preconditions for fis-

calization. Many countries proposed national budget surveillance enforcement as one of the main preconditions. Importantly, the EU member states, as opposed to the US states, did not criticize the current contribution based system of financing the EU as such. That is a sign that this system, notwithstanding its flaws, operates rather smoothly and the states contribute the sums that were agreed upon. This is a main difference with the requisition system in the US, in which the states did not contribute of what they should have and that was the main reason why the system was criticized so heavily. However, in the US, unlike the EU, there was no limit on the level of contributions that the Confederal Congress could request from the states. Moreover, those were requested during the American Revolution, and so at the time of war when the public expenses are the greatest. Other EU countries highlighted that this process of fiscalization should be gradual and that a clearly assigned division of competences between the member states and the EU should follow. Thus, fiscalization cannot be implemented for its own sake, but both sides - revenue and expenditure - of the future EU budget must be reformulated and clearly linked. Such a link was created in the US when general defense was clearly assigned as a task of the new federal government.

## 6.4 Summary

The most important finding of this research is perhaps the following: both the US and the EU experienced a shift of power in fiscal matters to the higher level of government, albeit in different forms. While in the US an endogenous threat emerging from the debt crisis triggered the process of fiscalization of the federal government, the EU, on the other hand, responded to a threat also caused by a debt crisis by strengthening its authority to regulate the fiscal policies of the member states. Fiscalization has been ruled out. Many of the changes that the EU has introduced, was a result of the economic and political pressure, or ‘necessities’, as Hamilton would call it. He would probably repeat an observation that he made to his fellow Americans, which has been cited at the beginning of the following chapter. Namely, that in politics such necessities often lead to ‘false hopes, false reasonings and a system of measures, correspondently erroneous’.

Correspondently, the lesson that the EU could perhaps learn from the US experience in forging a federal fiscal union is twofold. First, an endogenous threat is the necessary condition for triggering the process of fiscalization of the central government and consequently leading to the creation of a federal fiscal union. Second, the lack of a federal power to tax, and thus the existence of a vertical fiscal imbalance, as explained in Chapter 2.3, so that central government is financially dependent on the contributions from the states, may trigger a chain of events leading to popular protests that can threaten the very existence of the Union. One solution to such a crisis is the creation of a more ‘energetic’ federal government with the power to tax as its

most important competence. I elaborate more on these lessons in the following, concluding chapter.



# PART III CONCLUSIONS

## 7 The Insights for the EU from the US Federal Experience

*The first success would be apt to inspire false opinions; which it might require a long course of subsequent experience to correct. Necessity, especially in politics, often occasions false hopes, false reasonings and a system of measures, correspondently erroneous.*

Alexander Hamilton<sup>312</sup>

I have demonstrated that both the US in the 1780s and the EU in the 2010s experienced a sovereign debt crisis in their member states. I believe that there are four lessons or insights that the EU as a whole, and the Euro Area in particular, can learn from the US experience of resolving this crisis by the creation of a federal fiscal union. First, paradoxically, fiscalization tends to be preceded by a sovereign debt crisis. Second, fiscalization can trigger the democratization of central institutions. Third,

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<sup>312</sup> *Federalist* 35, PAH IV: 479.

any proposed fiscal union to be successful should be preceded by a wide debate, involving the citizens of the member states. Finally, the main opponents of fiscalization should be offered clear benefits that will result from giving up some of their tax power in order for fiscalization to be successful. I elaborate on those four insights in the following paragraphs below.

- 1) Paradoxically, fiscalization tends to be preceded by a sovereign debt crisis. If states are the only bodies with the power to tax, they will end up paying for policies which should be (or are) allocated at the central level, such as defence or bailouts of large banks, and as a consequence, they can run up huge debts. As a result, the states impose high tax burdens on their citizens (or cut spending) to pay off those debts. The high tax burdens can lead to tax protests (such as the Shays's Rebellion in Massachusetts in 1786/87). If present (or perceived as a threat) in a majority of the states, this kind of social unrest can threaten the very existence of the union. One solution to such a crisis may be the creation of a more 'energetic' union, with fiscal capacity, which could be used to provide Union-wide public goods, such as common defence.
- 2) Fiscalization can trigger the democratization of central institutions - in line with the rule 'no taxation without representation'. If such a wide power is given to the central government, this government must be reformed so that it represents both the people (in the US this is done through the House of Representatives) and the states (through the Senate), and different branches of the federal government can check and balance each other, so that the power to tax is not used excessively. In the case of the EU, it may well be that solving its fiscal deficit (i.e. a lack of tax power) will ease its democratic deficit, when the European Parliament will be given the power to tax and so the principle 'no

representation without taxation' will be addressed. Consequently, and perhaps paradoxically, the introduction of the federal power to tax can trigger even more integration - in the political domain. Significantly, in the EU some member states claimed that a political union should follow the EU fiscalization in order to ensure appropriate level of accountability. This is the argument, which appeared in both the EU, and US debates - it was maintained that a federal (supranational) fiscalization should be accompanied with changes in the structure of government, in order to ensure democratic legitimacy. In both polities it was understood that a power to tax, that the process of fiscalization would lead to, is such a great power that it cannot be granted to any level of government, unless this government is sufficiently representing both the people and the states.

- 3) Any proposed fiscal union should be preceded by a wide debate, involving the citizens of the member states. The people of the union must agree on such a measure and arguments for and against a federal tax power should be presented, as they were during the great debate on the ratification of the US constitution in 1787 and 1788. Today, the European-level regulation of national fiscal policies creates a great deal of hostility towards the EU institutions among the peoples of Europe. By contrast, the use of fiscal capacity could enable the citizens to see the benefits of the EU once again. For instance, by using a tax that could be only effectively levied at the EU level, such as financial transaction tax, which will not increase tax burden of the average citizen and may in fact reduce it - if the EU will manage to raise enough revenues and then use it to pay for expenditures that currently the member states have to pay for, like unemployment fund or common defence. A similar mechanism was at play in the US, when the federal government, once given the power to tax, raised six times more revenues than the states (see Table 2 in Chapter 4).



- 4) The main opponents of fiscalization should be offered clear benefits that will result from giving up some of their tax power. That was the case with New York, which had the most to lose from fiscalization, but at the same time was most exposed to the danger of invasion and thus saw benefits from federal government taking over the military expenses. In the case of the EU, those most critical towards fiscal union, should see that, in the end, the benefits resulting from the fiscalization of the EU might exceed its costs.

In an attempt to tackle the threat to the union, which a sovereign debt crisis constitutes, the US in the 1780s and the EU in the 2010s opted for two fundamentally different approaches. The US went for the fiscalization of the federal government, in which the new Constitution granted central government the power to tax. A sovereign debt crisis at the state level was the single-most important reason for this. The EU, on the other hand, followed the paradigm of regulation of the fiscal policies of its member states.

The theoretical underpinnings of this dissertation is the theory of the emergence of federations developed by William Riker (1964; 1975). A central element of his theory is the presence of the external military threat, which political leaders of both groups, those offering and those accepting the bargain to create a federation, wanted to defer by creating a 'larger and presumably stronger government'. This federal bargain takes the form of a constitutional 'deal', in which the political elites negotiate the terms of creating the new union. Importantly, as the main motive driving such a bargain is the presence of a military-diplomatic threat, the elites' desire for either defense or aggression is crucial. Both groups of politicians - the current rulers of the constituent units and the prospective rulers of the federation - must anticipate that the bargain would bring about substantive gains and as such would outnumber losses. For instance, the group which offers the bargain could use force, but abstain from

doing so, and thus must receive a reward - a peaceful integration. I analyzed both the perceptions of political elites that led to what I called a *fiscal bargain* and economic situation that led to such perceptions, putting special emphasis on the economic depression and fiscal crisis in the states in the mid 1780s in the US, and the Euro crisis in the 2010s in the EU. In doing so, I followed Riker's theory of threats.

The original contribution to knowledge of this dissertation to the analysis of the fiscal structures of the federal-like polities in general, and to the economic governance of the EU in particular, is, *inter alia*, the conceptual clarification; it was offered in Chapter 2.4 by introducing a concept of fiscalization, which was guiding the empirical analyses of Chapters 4 and 5 (for an overview of the contribution of this dissertation to both theoretical and empirical literature see Chapter 1.5). Consequently, I propose to use the concept of fiscalization, instead of fiscal integration which is without much meaning, because it does not indicate what kind of integration is meant - by the instrument of regulation or - fiscalization. The latter is sometimes referred to as a fiscal capacity (see, for instance Daniele and Greys [2015] for the example of the lack of clarification of such important concepts as 'fiscal union' and 'fiscal integration', which led to the use of these distinct concepts interchangeably and as a result - to a theoretical chaos, which may seriously undermine the findings of this study). However, a fiscal capacity and fiscalization should not be confused. While the former usually refers to the amount of resources that a given government can use, the latter adds one more condition to such a definition. Namely, such a government must have a power over the sources of those revenues, for instance a power to levy some kind of tax. If the EU would serve as an exemplification of these two concepts, in order to create a fiscal capacity, it would be enough to simply enlarge its budget, without changing the way it is financed. Thus, it could still be based on contributions from the member states. However, when one speaks of fiscalization of the EU, it would not be enough just to enlarge the amount of member states' contributions. Rather, the nature of the EU budget would need to change, and consequently it would have to

be given a power over a source of revenue, for instance a power to levy some kind of tax, such as a financial transaction tax.

As this dissertation has shown, such a power to tax was one of the most important features of the US Constitution and the lack thereof, that is - of the ability of a federal government to raise revenues from its own sources, has been identified as the main factor for the lack of sustainability of a federation and, at the same time, a weak point of the institutional architecture of the EU. Therefore, in a classical fiscal union such as the US, the federal government has the power to tax; however, it does not have the power to regulate the fiscal policies of the states. In the EU, we can observe the reverse situation: in the past few years, the European institutions have acquired a good deal of power to regulate national fiscal policies, but no fiscal power as such. The European budget is small (about 1 percent of the EU's GDP), and it relies almost exclusively on contributions from the member states.

For instance, the European Semester obliges member state governments to submit their budgets for the Commission's approval every year in November, even before they are sent to their own national Parliaments. Paradoxically, by not agreeing to give the EU fiscal power so that they could protect their fiscal sovereignty, member states gave up more of this very fiscal sovereignty to the central institutions, than states in classical federations, for example in the US. As a result, a Euro Area country that is hit by an asymmetric economic shock is not only deprived of using an exchange rates policy, but furthermore it cannot boost its economy by public spending because it is legally obliged to keep its deficit low. And because there is no European fiscal power, there are no automatic financial transfers from the European budget that could help to absorb such shocks.

In fact, an ability to accommodate asymmetric shocks was one of the most common arguments favoring fiscalization of the EU during the debate on the future of the EU in 2015. Most of the member states' contributions to this debate highlighted the fact

that fiscalization (or fiscal capacity, to use the language of the EU) is needed at some point in a long term, without specifying what this long term means. On the other hand, virtually all the contributions underlined a need for fully implementing EU fiscal regulations that were introduced as a result of the Euro Area crisis. This evidence confirms my hypothesis that fiscalization emerges as a result of an endogenous threat. Since the most acute phase of the Euro crisis is gone, the member states have not been willing to pool more sovereignty in the form of fiscalization of the EU. As a result, the EU followed an old paradigm of fiscal regulation.

However, this paradigm may change, as we observe a growing number of reports and proposals calling for an adjustment in the way that the EU is responding to the Euro Area crisis, and, ultimately, to use Jean Monnet's famous formulation,<sup>313</sup> for an adjustment to the form that Europe will take, as it will be forged as the result of this response.<sup>314</sup> In fact, the voluntary and unilateral Brexit gave a further impetus to such proposals.<sup>315</sup> It remains to be seen, however, if it will have similar consequences for the EU, as the forced British exit from America had on the future of the US two centuries ago.

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<sup>313</sup> 'Europe will be forged in crises, and will be the sum of the solutions adopted for those crises'.

<sup>314</sup> See for instance: Macron and Gabriel (2015), where then Economy Minister of France and from May 2017 the President of the Republic; and German Vice-Chancellor, called for the creation of a Eurozone budget with the tax and borrowing powers.

<sup>315</sup> See, for instance, a common statement of French and German foreign ministers issued few days after the referendum when the UK voted to leave the EU, where they called for establishing fiscal union by 2018: 'these (fiscal - author) capabilities should start by 2018 at the latest to support investment in the member states most severely hit by the crisis' (Ayrault and Steinmeier 2016: 9).



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