SECTION I
REGIONAL DEVELOPMENT STRATEGIES AND POLICIES

IS FEDERALISM BETTER FROM ECONOMIC POINT OF VIEW?

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Abstract

Everything we knew to be well-defined economically, politically and socially before COVID-19 seems like a thing of the past. The pandemic has swept all countries of the world, and Europe and especially the European Union makes no difference. Thus, this article aims to investigate empirically, through quarterly data, before and during the pandemic, whether federalism offers a better economic and social response compared to the unitary state regime, analyzing in tandem the realities of three federal states (Germany, Belgium and Austria) with developments of three states with other political regimes of the EU28.

Keywords: federalism, stabilization, crisis, EU28

JEL Classification: G01, E63, Z18

1. Introduction

The COVID-19 crisis has called into question the ability of unitary national states and federal states to meet these epidemiological political social and economical challenges. Therefore, the article tries to investigate on the basis of theoretical hypotheses the ability of these two groups of countries to fit into the paradigm of a superior stabilization through the prism of federalism features. The countries chosen within the European Union (EU28) as a federalist model are Belgium, Germany and Austria and for the model of the unitary state are chosen the Czech Republic, Poland and Romania.

2. Literature review

A lot of ink has flowed on the issue of federalism all over the world, on its positive and negative aspects. For example, from a political point of view, Bóka (2006) describes the federalism in Europe showing the differences between the oppositional current of EU politics: intergovernmentalism and federalism, concentrating on debating that the federalist ideas can overcome the concept of national state in terms of reducing conflicts and nationalist claims on the history of European countries.

Basically, in theory, federalism emphasizes on the government's ability to intervene strictly in certain issues, and not to interfere with the powers of states in other certain areas and to preserve the rights of individuals as well as possible. From an economic point of view, federalism focuses on the government in solving the failures of private markets and in meeting more the demands of consumers and citizens, debating the ability to centralize or decentralize political structures so as to achieve the goals as best as possible. Thus, Inman and Rubinfeld (2014) state that the choice for an "optimal" level of decentralization depends on the relative importance between economic efficiency and the potentially competing values of economic fairness, personal rights and liberties and political participation. They developed the classic Tiebout framework (Tiebout, C., 1956) taking into consideration the bargaining among governmental units.

According to Dorn (1990) under a federalist structure of government, taxpayer and consumers have greater freedom to respond to tax increases than under a unitary system of government, so the survival of the federal system is closely linked to the survival of the liberal

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economic order. When concerning stabilisation policies Boushey, Nunn and Shambaugh (2019) remark that federal taxes provide a substantial amount of automatic stabilization (and also the discretionary federal policy) but the state and local fiscal policy is slightly procyclical.

Thus, regardless of the perspective of approach (political, economic, ecological or social point of view), the federalism can be investigated by the multitude of its benefits or costs or by the features that it should perform in relation to other governing structures (e.g. unitary states). Therefore, the present study aims for a theoretical and empirical openness in this regard.

3. Methodology

The methodology is basically empirical, using correlation for explaining a bivariate relationship and comparisons of means and difference of means, with theoretical arguments and hypothesis formulations. The source of data is mainly Eurostat but they are used also political and economical studies. The sample size uses the data for 3 federative states (federal parliamentary republics and federal parliamentary constitutional monarchy) of European Union: Germany, Austria, and Belgium and three non-federal states (unitary parliamentary constitutional republic and unitary semi-presidential republics) like: Czech Republic, Romania and Poland, over the period 2018Q1-2020Q2. The instrument used was Excel and Excel data analysis. The notations are: AF and ADF- the average value of indicator respectively the average value of consecutive quarterly differential in federal states, ANF and ADNF - the average values respective the average value of consecutive quarterly differential of the indicator in non federal states, GGDS - General Government deficit (-) and surplus (+) as percentage of gross domestic product (GDP), GGGD- General government gross debt as percentage of GDP, UR – unemployment rate, as percentage of active population, RGDP – real gross domestic product growth rate, DINP – Direct investment calculated as net position of the country with the rest of the world expressed as percentage of GDP.

4. Results

Taking into account the theory and practice, considering that the Covid-19 determined a strong recession, the federal government must be theoretically able to counteract declines in economic activity by increasing spending (so higher deficits), even while revenues decline—making up the difference with additional borrowing (so higher public debt). At the same time, in recession the public income fall determines a decrease in public (state and local) investments and also a decrease of private investments. Also, bearing in mind the theoretically greater automatic and discretionary stabilization effect in federal states than in non-federal states of the EU28, the increase in government deficit and debt should not be greater than in non-federal states in the EU28. The collapse of public and private investment should also be mitigated in the federal states. The unemployment rate during a recession or crisis should increase but not more than in non-federal states. Economic growth should collapse more slowly in federal states than in non-federal states in crisis conditions.

All these assumptions will be verified on the average values of the above indicators of the three elected federal states (Germany, Austria and Belgium) and of the selected non-federal ones (Czech Republic, Poland and Romania)(see table no. 1).

Thus, regarding the *first indicator* of **the budget deficit or surplus as a % of GDP**, expressed as the average of the three elected federal states, we notice that the federal states managed the situation better than the non-federal states subject to analysis. Of the 10 quarters analyzed (2018Q1-2020Q2) 7 complied with the stated theory.

Table no. 1 – The average values of some macroeconomic indicators for three federal states and three non-federal states from EU28

		2018-Q1	2018-Q2	2018-Q3	2018-Q4	2019-Q1	2019-Q2	2019-Q3	2019-Q4	2020-Q1	2020-Q2
GGDS	AF	-1.6	3.1	-0.5	0.4	-2.4	2.5	-0.9	0.9	-4.3	-11.6
	ANF	-0.7	0.4	-0.5	-2.2	-1.0	-0.6	-1.1	-3.5	-5.3	-11.8
GGGD	AF	82.0	81.2	80.6	78.6	79.2	78.5	78.1	76.3	79.5	88.4
	ANF	40.3	39.8	38.9	38.5	38.8	38.1	38.0	37.2	39.4	45.4
UR	AF	4.9	4.7	4.7	4.6	4.5	4.3	4.3	4.2	4.4	4.7
	ANF	3.6	3.4	3.3	3.3	3.2	3.0	3.0	3.0	3.1	3.6
RGDP	AF	0.6	0.4	0.1	0.6	0.3	0.1	0.2	0.0	-2.6	-11.2
	ANF	0.8	0.9	1.2	0.7	1.0	0.7	0.8	0.7	-1.2	-10.0
DINP	AF	59.7	62.5	58.2	43.3	56.7	56.4	61.3	63.5	46.3	53.9
	ANF	-166.7	-163.3	-164.5	-165.1	-164.0	-161.1	-161.7	-161.0	-158.8	-174.2

Source: Author's calculation on Eurostat quarterly data. Notes: AF- the average value of indicator in federal states, ANF - the average values of the indicator in non federal states, GGDS - General Government deficit and surplus, GGGD- General government gross debt, UR – unemployment rate, RGDP – real gross domestic product growth rate, DINP – Direct investment calculated as net position of the country with the rest of the world. The federal states chosen are Belgium, Germany and Austria and the non-federal states are Czech Republic, Poland and Romania.

The public debt expressed as a percentage of GDP does not meet in any year the requirement to be under the public debt of the elected non-federal states, but except for the 2 quarters of 2020, when the pressures of the COVID -19 crisis manifested, the trend of was obviously declining in the federal states. The unemployment rate also underperforms the requirement to be below the level of non-federal states, although even in this case, by 2020, the trend is decreasing. However, the analysis of the difference will tell us something about the stabilization capacity regarding the indicator. Economic growth is also modest and below the average value of non-federal states, which is not surprising either from the perspective of stabilization or from the fact that the comparison is made with relatively emerging EU countries (Poland, Romania and Czechia), with rapid growth rates. What is worrying, however, is that the collapse of the growth of federal states exceeds that of non-federal states, but then we must analyze the pace of recovery of economic growth. The last indicator chosen DINP performs very well, in accordance with the theory, but table 2, regarding the correlations between the two types of countries will clarify us further.

Table no. 2 – The correlation matrix between some macroeconomic indicators for three federal states and three non-federal states from EU28

	GGDSF	GGDSNF	GGGDF	GGGDNF	URF	URNF	RGDPF	RGDPNF	DINPF	DINPNF
GGDSF	1									
GGDSNF	0.54	1								
GGGDF	-0.42	0.14	1							
GGGDNF	0.10	-0.14	-0.69	1						
URF	-0.36	0.06	0.86	-0.84	1					
URNF	0.05	-0.36	-0.69	0.31	-0.36	1				
RGDPF	0.74	0.74	-0.17	-0.24	-0.04	-0.11	1			
RGDPNF	0.77	0.74	-0.22	-0.18	-0.12	-0.09	0.97	1		
DINPF	0.21	0.25	-0.31	0.61	-0.45	-0.13	0.11	0.11	1	
DINPNF	0.37	-0.18	-0.99	0.65	-0.84	0.73	0.14	0.19	0.25	1

Source: Author's calculation on Eurostat quarterly data. The above notations are kept.

The correlation matrix must be viewed with caution, taking into account that for each pair of indicators (federal - non-federal) there are only 30 observations available, but still we can summarize some conclusions based on it:

- Indicators for federal and non-federal states have correlations with intensities high and generally positive (except the public debt and unemployment rate), suggesting a relatively homogeneous, but time-lagging evolution between the two types of states chosen,

- The correlations between federal and non-federal states regarding public debt and unemployment rate are negative, highlighting reverse trends, suggesting a trade-off between high debt and absorbed immigrant labour (for federal states) and low debt and labour expelled abroad (for non-federal states),

- Although positively correlated, the volume of direct investments expressed as a net position (% of GDP) have an extremely low intensity of correlations suggesting an increased inability of non-federal states to connect to the flow of direct investments that feed federal states,

- Direct investment in non-federal states is incapable of improving in any way the unemployment rate situation in non-federal states under analysis but seems extremely strongly correlated negatively with the evolution of the unemployment rate in analysed federal states,

- The high intensity (over 70%) of the correlations of the economic growth rate in federal and non-federal states with the budget balance in federal and non-federal states suggests the increased importance of budget balance and the spill over effect not only on the welfare of the analyzed group of countries (differences between federal and non-federal countries flattening) etc.

Analyzing the quarterly variation of the averages on the group of countries (federal and non-federal) or delta we can obtain additional information about the macroeconomic stabilization capacity of the federal states (see Table no.3).

Table no. 3 – The average values of delta or deferential of some macroeconomic indicators for three federal states and three non-federal states from EU28

		2018 Q2-Q1	2018-Q3-Q2	2018-Q4-Q3	2019-Q1-Q4	2019-Q2-Q1	2019-Q3-Q2	2019-Q4-Q3	2020-Q1-Q4	2020-Q2-Q1
	ADF	4.7	-3.7	1.0	-2.9	5.0	-3.4	1.8	-5.2	-7.3
GGDS	ADNF	1.2	-0.9	-1.7	1.1	0.4	-0.5	-2.4	-1.8	-6.5
	ADF	-0.8	-0.6	-2.0	0.6	-0.8	-0.4	-1.8	3.2	8.9
GGGD	ADNF	-0.5	-0.9	-0.4	0.2	-0.6	-0.1	-0.8	2.2	6.0
	ADF	-0.2	0.0	-0.1	-0.1	-0.2	0.0	-0.1	0.1	0.3
UR	ADNF	-0.2	-0.1	0.0	-0.1	-0.2	0.0	0.0	0.1	0.5
	ADF	-0.2	-0.3	0.4	-0.2	-0.3	0.1	-0.2	-2.6	-8.6
RGDP	ADNF	0.1	0.3	-0.5	0.3	-0.3	0.0	-0.1	-1.9	-8.8
	ADF	2.85	-4.31	-14.98	13.42	-0.25	4.90	2.17	-17.24	7.61
DINP	ADNF	3.38	-1.11	-0.63	1.05	2.93	-0.62	0.74	2.17	-15.35

Source: Author's calculation on Eurostat quarterly data. The above notations are kept. The ADF is the average value of delta for federal states from EU28. The difference between quarters refers to the consecutive quarters.

And in this situation, the deficit positions federal states better than non-federal ones; public debt is almost identical during the analysis period in the two groups of states (federal and non-federal) with the nuance that federal states seem to accelerate the trend of debt reduction; the unemployment rate shows decelerations in five of the nine moments analyzed compared to only four decelerations regarding non-federal states; economic growth in the federal states shows only two favourable moments compared to four in the non-federal states out of the nine time moments analyzed and direct investment shows only four favourable

moments of the quarterly differential in the federal states compared to the five of the non-federal states analyzed. This aspect demonstrates that the fiscal and social fiscal elements are well articulated in public policies in the federal states compared to the non-federal states.

At the same time, if we strictly analyze the idea of stability, in the sense of the minimum deviation, in the absolute sense, of the quarterly differential of federal states compared to non-federal states (see Table no. 4) we notice that only the indicator of real GDP growth rate conforms to this concept. Thus, the federal states present a better stabilization effect (automatic and discretionary) of public policies on the economy as economic theory also says. This aspect is also seen through the minimal variations of the indicators belonging to the real economy (unemployment, economic growth, direct investments) during the manifestation of the beginning of COVID-19 crisis (first half of 2020).

Table no. 4 – The conformity of the average values of delta of some macroeconomic indicators for three federal states from EU28 with the concept of stability

		2018 Q2-Q1	2018-Q3-Q2	2018-Q4-Q3	2019-Q1-Q4	2019-Q2-Q1	2019-Q3-Q2	2019-Q4-Q3	2020-Q1-Q4	2020-Q2-Q1
GGGDS	ADF	0	0	1	0	0	0	1	0	0
GGGD	ADF	0	1	0	0	0	0	0	0	0
UR	ADF	0	1	0	0	1	0	0	0	1
RGDP	ADF	0	1	1	1	1	0	0	0	1
DINP	ADF	1	0	0	0	1	0	0	0	1

Source: Author's calculation on Eurostat quarterly data. The above notations are kept. The ADF is the average value of delta for federal states from EU28. The difference between quarters refers to the consecutive quarters. Value 1- expresses the fact that the absolute value the delta of federal states is less than of the non-federal states.

Also we can look at things from the perspective of the higher effort to comply with the real needs of the economies and to align the quarterly differential of the indicators to a desirable level, also comparing the federal states with the chosen non-federal ones (see Table no.5).

Table no. 5 – The conformity of the average values of delta of some macroeconomic indicators for three federal states from EU28 with the need for greater fulfilment of the indicator in federal states compared to non-federal states chosen

		2018 Q2-Q1	2018-Q3-Q2	2018-Q4-Q3	2019-Q1-Q4	2019-Q2-Q1	2019-Q3-Q2	2019-Q4-Q3	2020-Q1-Q4	2020-Q2-Q1
GGGDS	ADF	1	0	1	0	1	0	1	0	0
GGGD	ADF	1	0	1	0	1	1	1	0	0
UR	ADF	0	0	1	1	0	1	1	0	1
RGDP	ADF	0	0	1	0	1	1	0	0	1
DINP	ADF	0	0	0	1	0	1	1	0	1

Source: Author's calculation on Eurostat quarterly data. The above notations are kept. The ADF is the average value of delta for federal states from EU28. The difference between quarters refers to the consecutive quarters. Value 1- expresses the fact that the value the delta of federal states represents the increased effort of fulfillment than of the non-federal states.

Thus, we can observe that considerable efforts are being made to comply regarding the public debt and the unemployment rate, while other indicators are approaching that desirable level between what indicators should do in federal states compared to non-federal countries.

5. Conclusions

The crisis triggered by COVID-19, which is unfortunately still in full development, has so far put pressure on not only the medical system but also the world's economies. Preserving the economic and social parameters as much and as well as possible thus seems a good reason to reflect on the opportunities offered by a federalist model of government. Thus, the article aims at investigating, on the basis of few theoretical assumptions, the ability of these two groups of countries - federal states (Belgium, Germany and Austria) and non-federal (Czechia, Romania and Poland) of EU28 – of fitting into the paradigm of a superior stabilization through the prism of federalism features.

Thus, although at first glance, from the chosen indicators only the budget balance expressed as a percentage of GDP and the net position of direct investment expressed as a percentage of GDP seem to correspond to a good economic compliance for the elected federal states, we note that based on quarterly differential values the analysis changes its conclusion.

We can thus notice that the analysis from quarter to quarter, comparing the federal states with the non-federal ones, pushes from the chosen macroeconomic indicators those of the real economy in the sphere of compliance with what a federal state would imply - a better macroeconomic stabilization.

The results of the study should be viewed with caution in the light of the small number of observations and short-term analysis - a certain limited period of time, only certain EU countries. Sophisticated econometric analyzes, with extended periods, with large groups of countries with well-formulated theoretical and practical hypotheses can constitute new fields of research for future studies.

6. Bibliography

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***New Release, 184/2019 - 5 December 2019, GDP main aggregates and employment estimates for third quarter 2019 GDP up by 0.2% and employment up by 0.1% in the euro area In the EU28, GDP up by 0.3% and employment by 0.1%
***New Release,41/2020 - 10 March 2020, 2020 GDP main aggregates and employment estimates for fourth quarter 2019 GDP up by 0.1% and employment by 0.3% in the euro area In the EU27, GDP up by 0.2% and employment by 0.3%

***New Release, 168/2020 - 13 November 2020 ,GDP and employment flash estimates for the third quarter of 2020 GDP up by 12.6% and employment up by 0.9% in the euro area In the EU, GDP up by 11.6% and employment up by 0.9%

***New Release, 168/2020 - 13 November 2020, GDP and employment flash estimates for the third quarter of 2020 GDP up by 12.6% and employment up by 0.9% in the euro area In the EU, GDP up by 11.6% and employment up by 0.9%

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7. Annex
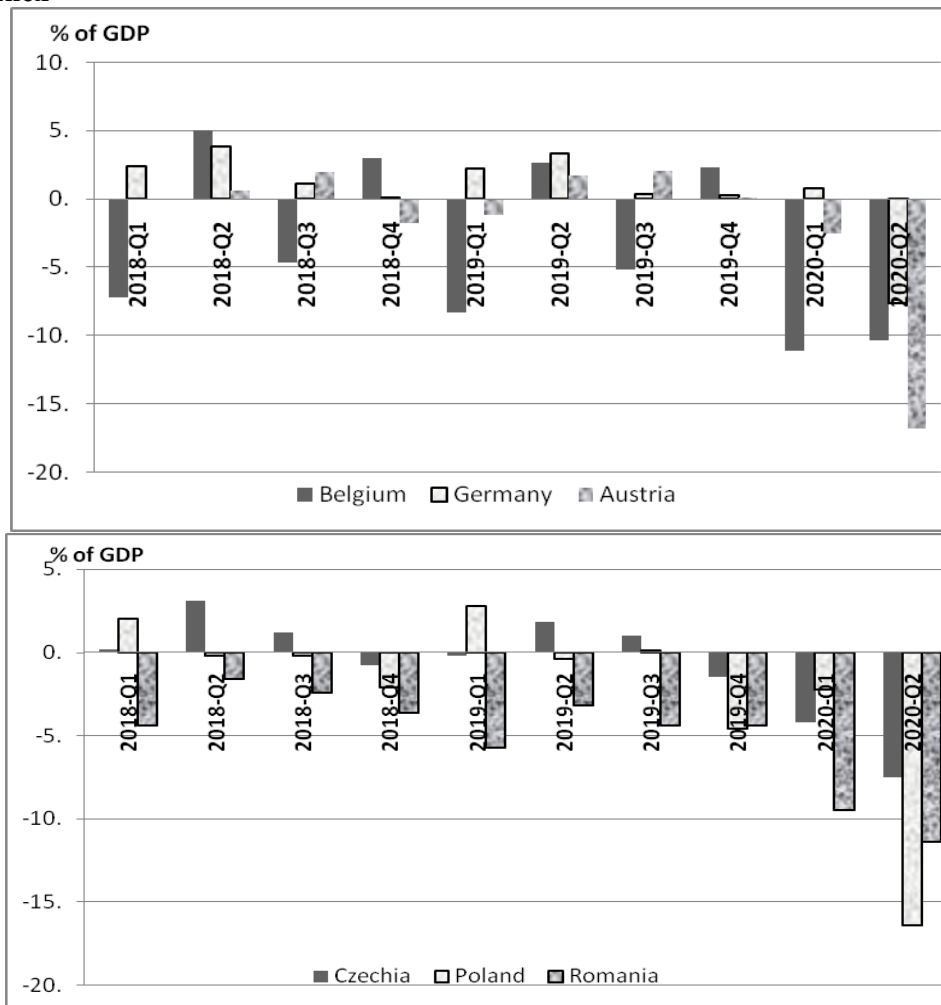
Figures no.1 – General government deficit (-) and surplus (+) as percentage of GDP for three federal and three non-federal states
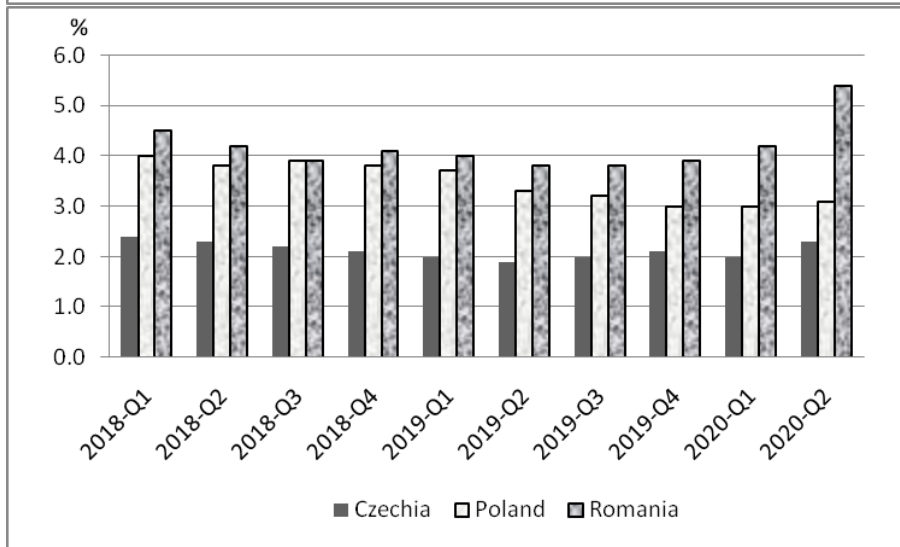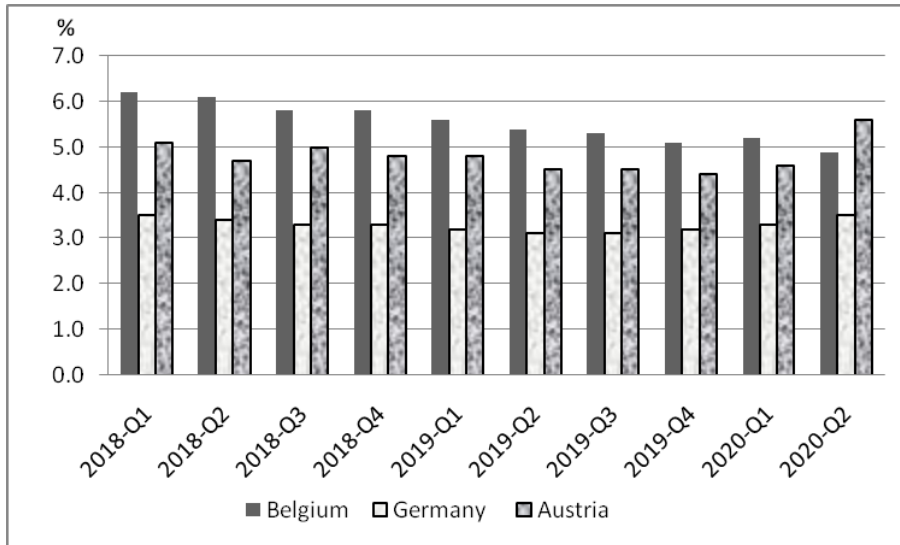
Source: Eurostat, quarterly data.

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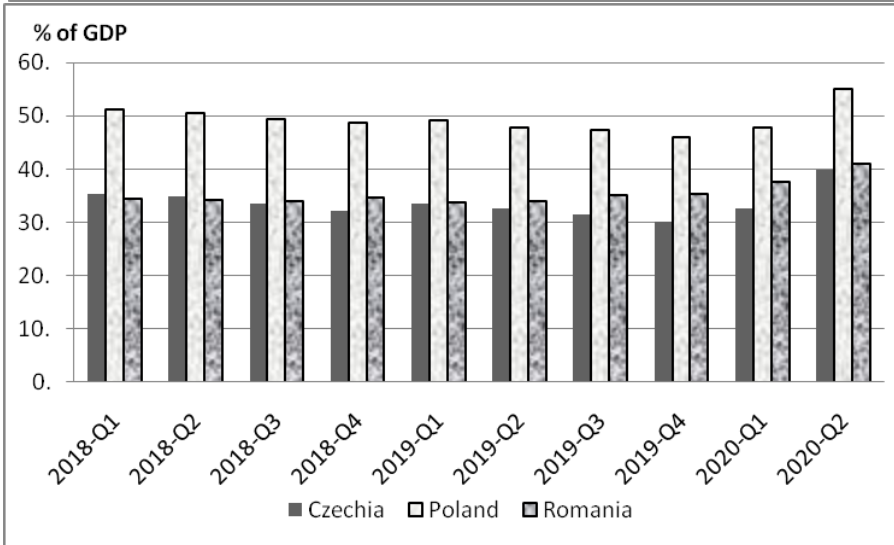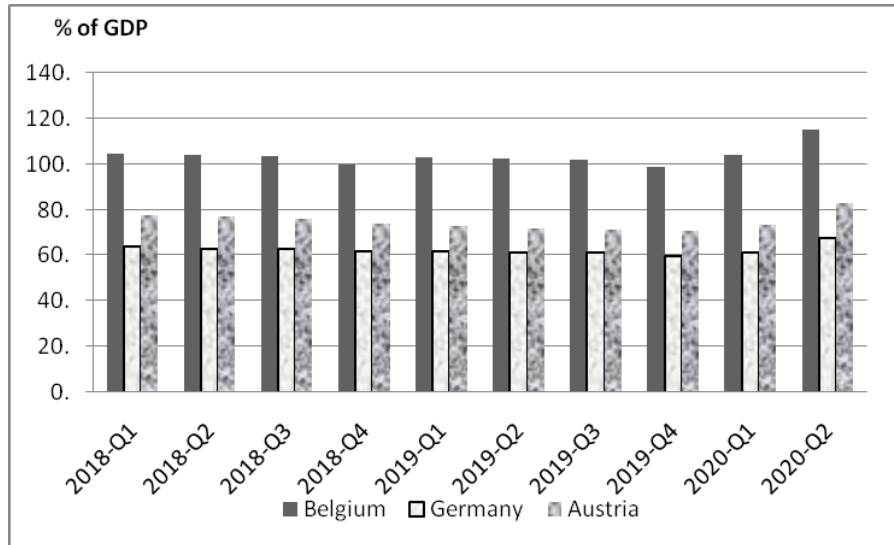
Figure no. 2 – General government gross debt as percentage of GDP for three federal and three non-federal states

Source: Eurostat, quarterly data.

Source: Eurostat, quarterly data, seasonally adjusted but not calendar adjusted data.

Figure no. 3 – Unemployment rate as percentage of active population for three federal and three non-federal states
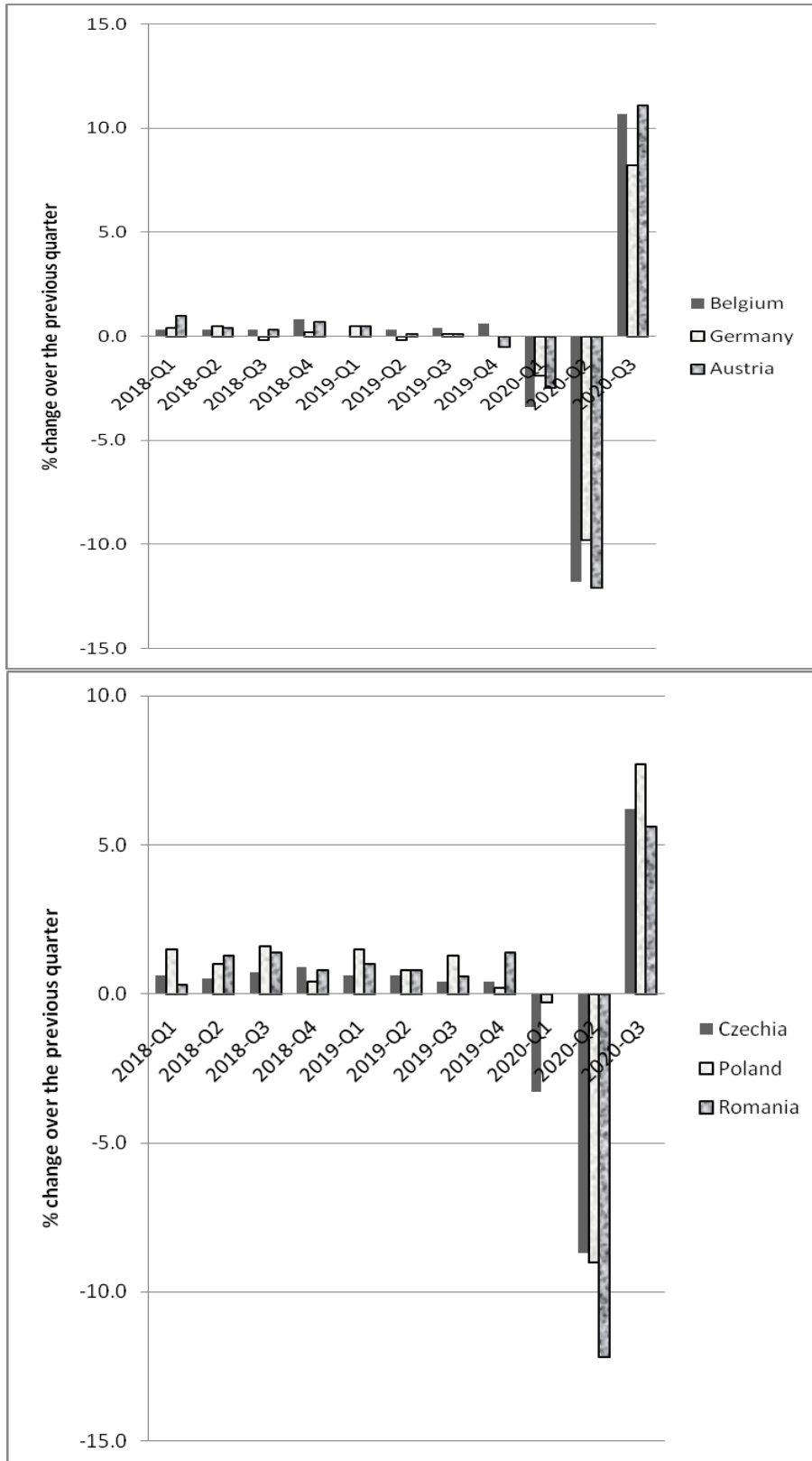
Figure no.4 – Real GDP growth rate for three federal and three non-federal states
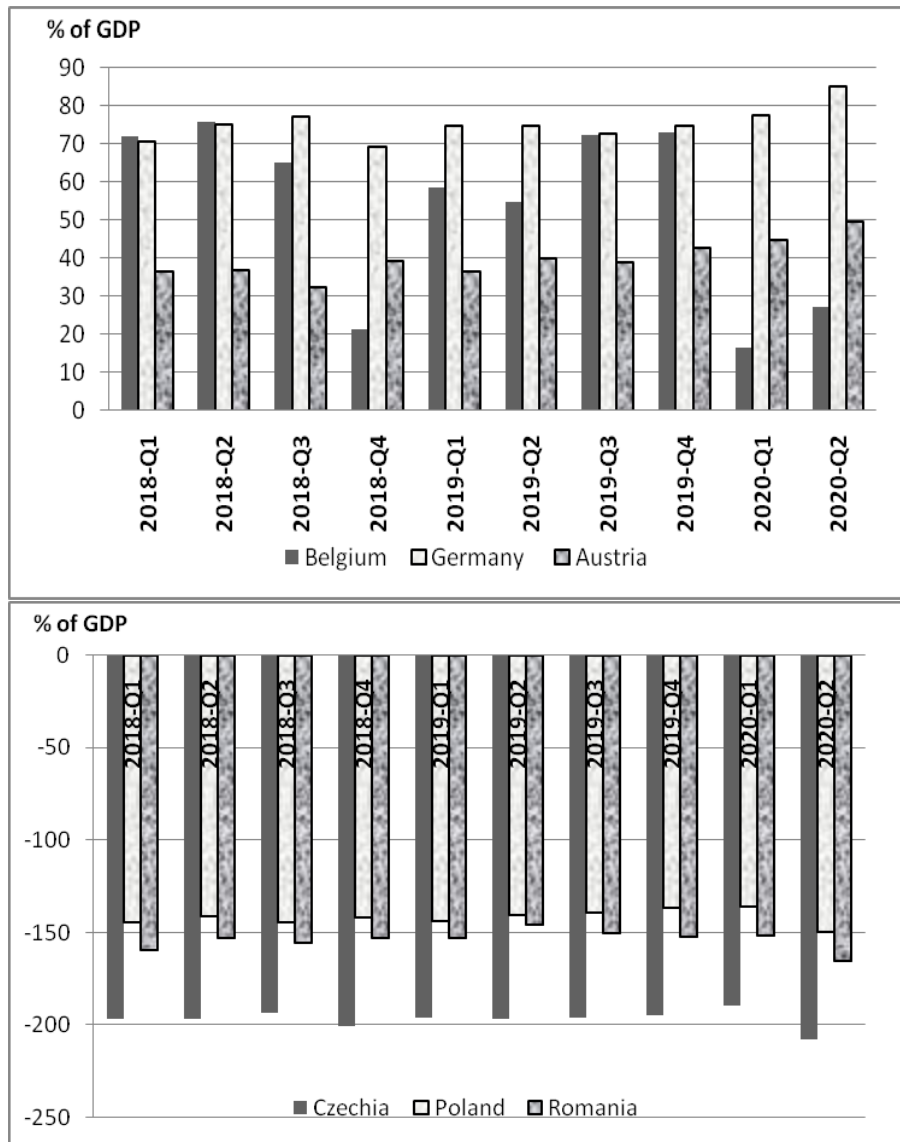*Source: Eurostat, quarterly data, seasonally adjusted.*

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Figure no.5 – Direct investment as % of GDP, net position at the end of the period
Source: Eurostat, quarterly data.