An analysis of the concept of fiscal federalism in relation to the European Union

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Sophie Ward makes the case that although the European Union has been a great success in some respects, in others it has been let down by an unwillingness to cooperate in areas outside of the common market. Fiscal federalism is one issue which must be resolved if the Union is to continue to build on its achievements. As Ward points out, enhanced coordination of fiscal policy will generate benefits for all of the EU members and does not necessarily have to be brought about by a centralisation of power which has in the past concerned Europeans.

Introduction

"It is better to be broadly right than precisely wrong"

John Maynard Keynes

Perhaps Winston Churchill, having watched his country wrecked on the rocks of war, believed just this as he stood in front of Europe in Zurich in 1947 pleading for a 'United States of Europe'. Was this the thinking of Robert Schuman during his 1963 speech where the 'European Federation' was envisaged as the product of the new integration process? With these came the inevitable split of views, those of the economist and those of the politician. The economist is far more likely to favour the confederate approach than the politician or sociologist.

The path of integration so far has been an economic one; a fight for an efficient market structure in which each member state may be allowed to flourish independently. Labelling Europe with 'fiscal federalism' is inopportune as it conjures an image of strong centralisation, when in reality, nations seek to allow the economics of multi-levelled governance to efficiently allocate, stabilise and distribute the various resources of Europe as close to the beneficiaries as possible. It also implies that its primary concern is financial when in fact it also concerns deeper issues of regulation and policy in Europe (Oates, 2002).

The fiscal federalism theory

> *"The promise of federalism is a straightforward proposition that has shown up time and again in political and economic theory from Montesquieu to James Madison to Richard Musgrave."*
>
> Rodden (2006: 5)

The number and depth of theories of fiscal federalism is clear. Rodden (2006) describes the idea from an economic point of view; a view that seems much simpler and based on the task at hand, as the 'optimal assignment of government authority'. The very *sui generis* nature of Europe means that it is difficult to apply traditional theory on fiscal federalism such as Bird (2003), Inman and Rubinfeld (1992) or Oates (2002). The European Union (EU) is a truly unique entity. However, fiscal federalism theory is one from which the EU has taken many of its characteristics, so its general features shall be considered here.

The outline provided by Bird (2003)[1] to describe the purposes of a general theory on fiscal federalism will be considered. One must ask:

1) Who is in charge of raising and allocating funds for activity within the 'federal' community?
2) Who is responsible for the taxation of what and hence where the tax revenue should go?
3) How should expenditure and tax revenues be distributed amongst the levels of government within the community? A correction of vertical imbalance.
4) How should expenditure and tax revenue be allocated amongst government of the same level? The correction of horizontal imbalance.
5) How much should members of the community be allowed to borrow; or the amount of debt they may be allowed to accumulate as a direct influence on the macroeconomics of the community?
6) What form should governments and institutions within the community take? The decision-making procedure.

[1] Adapted from Begg (2009)

What is clear in every theory is the application of subsidiarity in governance. Such a theory will come with trade offs and insufficiencies. These trade offs generally highlight the need for decentralisation in a fiscally federal system. Each comes with a related discussion.

Diversity and local information advantages versus scale economics

Differences in preferences between the member states of a community will make it inefficient, even just from a cultural viewpoint, for there to be a purely centralised government. Local governments have superior information about the people in the area under their control. When applied appropriately, subsidiarity can ease the information asymmetries arising from adverse selection and moral hazard. For example, consider the United States' experience of trying to solve the problem of unemployment within its states (Inman & Rubinfeld, 1992). States had to contribute to a central insurance fund, according to historical employment figures and could withdraw from the fund during periods of trouble. The fact that the level of contributions was decided based on published figures removed moral hazard. Furthermore, as every state was obliged to participate, adverse selection was averted. Overall, it was a novel way of managing asymmetric shocks within the community.

The level at which a decision is made should be chosen at the least cost, considering that it can be costly to accumulate information and implement policy. This is balanced against the possible economies of scale that can arise from high-level decision making. For this reason, an economist might like to place a decision at the highest level possible in the trade off between cost and efficiency of policy.

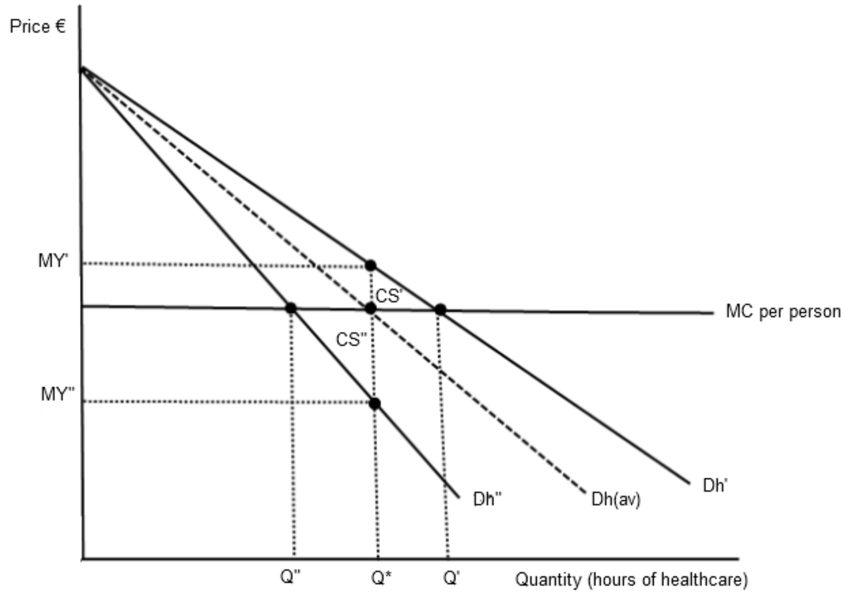

Figure 1: Analysis of consumer surplus at different levels of decision making

Figure 1 demonstrates how the analysis of consumer surplus may be used to show how inappropriate high-level decision making can be inefficient. This diagram illustrates how demand for healthcare is determined for two different regions (D_h' and D_h"). If this decision were to be made centrally, an average demand curve would be assumed (D_h^{av}). In this case, at the optimal position (intersection of D_h^{av} and marginal cost (MC) curve) both regions are worse off than in the decentralised case. Both regions are now paying the same taxes for the service. Region '' is paying for too much for the service and therefore, incurs a loss of consumer surplus as highlighted by the area CS". Region ' is not receiving enough healthcare for their needs since they are no longer generating enough tax revenue, so they lose consumer surplus of the amount highlighted by the region CS'. These losses represent a loss of efficiency for the entire community. Therefore, centralisation can only apply where there is parity in needs.

Figures 2 and *3* show how general equilibrium analysis can be used to show that centralisation can only apply where there is parity in preference. The diagrams show how the rural and urban speed limits are chosen in member states.

The 'budget constraint' is given by:

$$C = f(G, R, Q, L, S).$$

Where: G = Gradient variation of roads,
R = Rural/urban density
Q = Surface quality
L = Number of lane
S = The sinuosity ratio of the road.

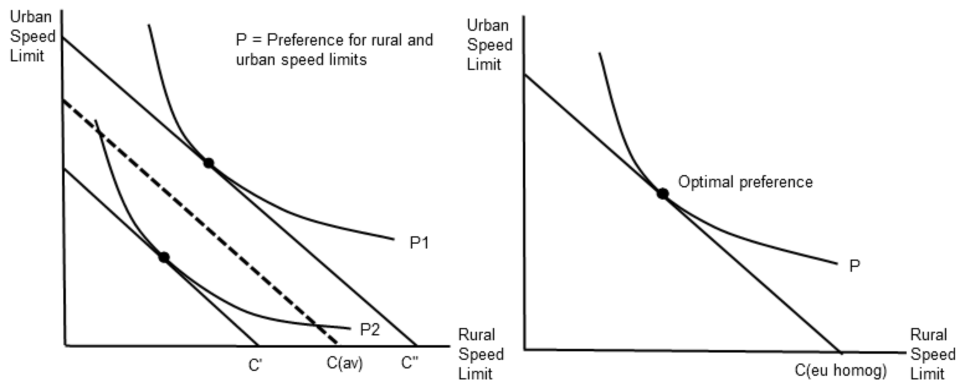

Figure 2: Indifference analysis under different road conditions (1) and homogenous road conditions (2).

In *figure 2(1)*, each country arrives at a different indifference curve due to the variables above differing from one another. As is evident from this analysis, having the same standard for speed limits throughout the community cannot work. In *figure 2(2)*, the countries have homogeneous road conditions and so can have the same preference for speed limits. Therefore, these regions could have a cost effective and centralised policy with the same road taxes to raise the revenues for road improvements. Economies that have arisen via a joint decision-making process are more likely to favour a centralised system.

Spillovers
These occur due to externalities from one region of a community impacting on another. They may be positive or negative. The impact of an army has a significant positive spillover effect since the presence of just one army in the world, with fairly free movement, will deter aggression. On the other hand, the impact of negative spillover effects are currently being felt by Irish retailers due to the disparity between Value Added Tax (VAT) rates in the UK and Ireland of 15 per cent and 21

per cent respectively. This has incentivised many Irish consumers to travel to Northern Ireland to shop[2]. This has been of great benefit to the UK market, but detrimental to the Irish one. These spillovers are important to note, even when positive, as they suggest that decision-making may be better handled at a higher level. Spillovers can imply parity of preference in different areas of the economy which are affected by them.

Democracy as a control mechanism

One of the major arguments for federalism comes from the fact that higher level government eases some of the issues arising from conflicts of interest. One assumes in a democratic society that governments act purely in the citizens' best interests. In reality, favouritism exists in government with the use of tax breaks and subsidies towards inefficient causes. The British national treasure MG Rover, for example, was bailed out repeatedly by the UK government under the pretence of saving jobs before finally going into administration. This cause was anti-competitive and the organisation of competition at supranational level could potentially have avoided this. Such behaviour is also present in pre-election propaganda. Election package specificity tends to increase as its' geographical incidence decreases. This argues in favour of centralisation.

Jurisdictional competition

Conversely, centralised governance takes away some of the competition between regions. This then removes power from the citizens who can no longer use their exit from jurisdiction as a signal of their desire for change. Thus, where intra-jurisdictional competition is heavy, governance is likely to be improved.

Is centralised or decentralised government more appropriate? The USA and Canada show, that where vertical redistribution and the taxation system dominate, there will be a lean towards centralisation. The lesson from Australia and Switzerland is that, where more horizontal redistribution occurs, it is more efficient to use a decentralised structure. Politically as well as economically, decentralisation is considered to be preferable in all cases where the marginal cost of policy may be met at the respective level (Ahmad & Brosio, 2006). It is also clear that to have efficiency, results-driven policy, decisions should be referred to the lowest possible level.

Applications and aims for EU nations

[2] See Kate Holohan's (2010) analysis: "Factors that influence the exchange rate: purchasing power parity – does it hold?" - for a more in depth discussion on this topic.

> *"One basic formula for understanding the Community is this: 'Take five broken empires, add the sixth one later, and make one big neo-colonial empire out of it all."*
>
> Professor Johan Galtung

These words were written at the start of the European integration project by an outsider but show how the aim of the EU has changed since its inception. The aim of fiscal federalism is to share the provision of public goods, the redistribution of income, the act of macroeconomic stabilisation and taxation between the four levels of government available in the EU: local, provincial, national and EU. This can be achieved via a supranational 'community competence' or a cooperative 'shared competence' (Baldwin & Wyplosz, 2009). This is sought through the application of the principle of subsidiarity, that decision making should take place as close to the people as possible, as outlined by the 1992 Maastricht Treaty.

The EU needs fiscal federalism because within the European Monetary Union (EMU), countries forego control over monetary policy. Upon this monetary base, fiscal policy has become the key to macroeconomic stability in the respective Eurozone countries. It is especially important to consider fiscal policy efficiency in the EU, since it can have an inflationary effect. Economic coordination is also necessary because discretionary fiscal policy tends to be unreliable due to its relationship with the political business cycle. A prime example is the recent EU experience of Greece's lack of fiscal responsibility. The effect on financial markets, throughout the community via contagion effects, has been considerable.

Fiscal federalism came with the introduction of the Three Pillar structure and the Maastricht Treaty. The level of national sovereignty and decision-making power of member states lies within these pillars:

1) Pillar 1 commands full authority of the 'community competences': the European Single Market, agricultural policy, competition policy, trade policy and the 'four freedoms': goods, services, labour and capital. It involves the complete transfer of national sovereignty and national courts may be overruled. This is acceptable only because there is considerable parity in national preference over such issues and definitive gains from scale economies. The transfer is diluted because decisions must be made unanimously; unlike the qualified majority voting accepted in the following 'shared competence' policy areas.

2) Pillar 2 is concerned with the foreign and security policies common to all EU member states. There are also gains in scale economies here, but disparity in national preference exists.
3) The issues of pillar 3, justice and home affairs, lie somewhere between pillars 1 and 2 in terms of the possible benefits of economies of scale and national preference (Baldwin & Wyplosz, 2009).

More recent reforms in decision making have included the 'flexibility' principle of the Treaty of Rome. The more extensive reforms, due to the recent community wide ratification of the Lisbon Treaty, seek to extend the competences of the EU. Such an aim inevitably involves further transfers of sovereignty within the community and contributed significantly to the difficulty of its ratification in Ireland and the Czech Republic. The ambiguity in preference and the scale of pillar 3 issues, led to the eventual agreement that the transfer of these competences into pillar 1 and the accompanying loss of national sovereignty, were acceptable under the Treaty. The intricacies of the deal are more political than economic in nature.

European fiscal federalism in practice

Economics has been the main focus of centralisation of the EU with the introduction of the Single Market and its associated freedoms. In terms of the 'Musgrave three-function framework' (Buchanan & Musgrave, 1999), stabilisation has taken precedence so far in the Community, due to the focus it takes from fiscal and monetary policy.

Imbalances between regions are much more pronounced than in other federations. Using CIA (2005) figures, the average Gini Index in the EU was 31, and ranged from 23 in Sweden to 38 in Latvia. The spread in the USA was much smaller, ranging from 41 in Alaska to 49.5 in New York. The situation in Europe is likely to be worse if Turkey joins with a Gini Index of 43.6. The extent of decentralisation in the redistribution of income leads to a loose comparison to traditional models of fiscal federalism. It is more appropriate to compare the progress of the EU to the conditions for 'market preserving federalism', a sort of economics of multi-level governance[3].

F1: Hierarchy of governance

This typically requires a deeply functionalised type I federal government. The EU's type II style of *ad hoc* governance allows supplementation of a base with extra

[3] Adapted from (Weingast, 1995)

arrangements for specific policy by virtue of its pillar structure. Unless there is some increase in the budget, it is unlikely that much more financial autonomy can be expected at the centre despite the ratification of Lisbon. This condition is considered by Weingast (1995) to be the primary requirement for federalism, a community cannot hope to be fiscally sound or market preserving without the other four conditions.

F2: Primary economic authority for national governments

Autonomy has remained high in member states, with the Bank of England's controversial quantitative easing programme and even within the Eurozone, with the Irish central bank's National Asset Management Agency (NAMA). However, the definition of fiscal responsibility in member states remains rather weak, most precisely with the under provision of expansionary fiscal policy due to its' spillover effects. It is also worth noting the disincentivising effects of provision of public goods in the EU[4].

F3: Authority to police the common market

Any violations of the common market are subject to prosecution by the EU court. The court may also overrule the national courts of member states. Most typically, these cases would be due to anti-competitive behaviour - many high profile cases are over mergers, like the GE-Honeywell merger, or misbehaviour in labour markets.

F4: Budget constraint by national governments

The Stability and Growth Pact (SGP) was adopted in 1997 in order to control the fiscal behaviour of member states in order to maintain the EMU and economic integration. In this sense, it is perhaps the ultimate example of how the EU has become fiscally federal. It orders that public debt must be below 60 per cent of GDP and that the budget deficit may not exceed three per cent. In this sense it constrains the budgets of national governments. However, recent experiences have shown this to be ineffective.

F5: Protection of delegation against national alteration

The inception of the EU court sought to achieve just this. The action of either unanimous or qualified majority voting of EU pillar issues means it is difficult for coalitions of member states to unite against a policy (though one can never be sure of what goes on between national leaders at supranational meetings).

[4] Tiebout (1956) saw this effect from spillovers and provides a comprehensive analysis.

There is a distinct national bias in Europe throughout these conditions. If the political horizon for a policy is shorter than its social horizon, the political business cycle will tend to increase the amount governments borrow, and produce lower than optimal tax rates. This supports the lengthening of the presidency of the EU Council's term of office and also for continued reform of the SGP, which has been accused of bias towards larger EU nations, especially during times of economic difficulty. Furthermore, centralisation is reinforced by Roubini and Sachs (1989) who found that Organisation for Economic Co-operation and Development (OECD) countries with decentralised legislatures tend to spend more and have more frequent turnover of their governments. The relationships between the different tiers of government in the EU seem to be marred by historical interaction rather than by the principles of fiscal federalism.

Conclusion

As revealed by the above analysis, Europe conforms to a traditional model of fiscal federalism but it may be more appropriately compared to a model of market-preserving federalism. Next, Europe should progress to achieve Oates' (1977) first generation fiscal federalism: economic federalism whose focus is on horizontal and vertical equity.

One should expect to see an increase in the EU budget, perhaps to three per cent of EU GDP, to produce more financial autonomy at the centre of the Union. Furthermore, it is reasonable to expect an increase in competences for the EU and further reformation of the SGP. This could include a broader application of the majority voting process to increase decision-making efficiency.

With the increasing proportion of 'peripheral' nations in the EU, a coherent method of managing asymmetric shocks must be defined. Without this, the required macroeconomic stability cannot be expected. Perhaps, an acceptable form of a 'European Constitution' should be considered to pursue these aims transparently.

By achieving this, the EU can hope to build towards second generation fiscal federalism, whereby efficient, transparent fiscal policy can be applied to a more homogeneous political economy to inspire economic growth and solid stability across member states.

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