

## FISCAL FEDERALISM AND EUROPEAN UNION: SOME REFLECTIONS

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## FISCAL FEDERALISM AND EUROPEAN UNION: SOME REFLECTIONS

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These are fascinating times for the study of fiscal federalism. On one hand, we are witnessing widespread efforts at devolution in both industrialized and developing nations, as countries seek to improve the performance of the public sector by bringing decision-making closer to the people. On the other hand, we see in Europe the evolution of a new top layer of government that introduces more centralized policy-making. And this has been further accompanied in some countries by the formation of «special districts,» units of government formed to address specific functions across existing or newly defined jurisdictions. The multi-level character of government seems to be taking on an increasingly complex character.

In retrospect, I sometimes wonder if «fiscal federalism» was an unfortunate choice of terminology. For those outside the field, and particularly for non-economists, it suggests a rather narrow concern with fiscal (or purely financial) relationships between different levels of government. But the scope of this area of inquiry is much broader than this. It addresses what might be better called «the economics of multi-level government,» the roles of the different levels of government, and it encompasses regulatory, as well as fiscal, functions and policy instruments. At any rate, public-finance economists know what they mean by the term.

The literature in fiscal federalism over the past forty years has developed a conceptual view of multi-level government finance. This «view» is certainly not a detailed blueprint, or rigid set

of principles or rules, but rather a conceptual overview that provides some general guidelines for federal finance. It explores, for example, the assignment of functions to different levels of government, as well as the design of systems of taxation and intergovernmental grants. It is interesting that much of the literature, especially the part addressing the assignment of functions, has been developed in the context of the modern nation-state. From this perspective, it presumes a substantial and strong central government with monetary, fiscal, and regulatory powers. As such, it doesn't seem to fit very well the cases of emerging «confederations» such as the European Union. Nevertheless, using the fiscal federalism model to think about the European Union does, I think, provide some useful insights. My purpose in this paper is to explore this issue further—to see what the fiscal federalism literature has to contribute to our understanding of the structure of the public sector in the European Union. In the first section of the paper, I shall go back quickly over some familiar ground with a brief review of some of the central ideas in this literature. Section two then moves on to use this framework to explore some issues—including some potentially troubling problems—that seem inherent in the new European public sector. The latter part of the paper takes up the design of fiscal and regulatory institutions and instruments. Getting the proper assignment of functions isn't enough; a high level of public-sector performance also requires a coherent set of fiscal and regulatory institutions that embodies incentives for effective policy-making.

### 1. On the Assignment of Functions

A central issue addressed in the literature on fiscal federalism is the economic roles of the different levels of government (e.g., Oates 1999). What specific tasks or responsibilities are the

various levels of government best equipped to handle? The literature does not provide an absolute set of rules—or inviolable principles—on the assignment issue, but it does offer some general guidelines that provide a point of departure for thinking about this issue in the context of particular countries (or groups of countries like the EU). It seems clear, for example, that the macroeconomic stabilization function must reside primarily with the central government. The central government typically has at its disposal the power to regulate the supply of money and credit and, perhaps, some exchange-rate prerogatives. Likewise, countercyclical fiscal measures are most effectively exercised at the central-government level. A local government, for instance, could not expect to get much expansionary punch from a cut in local taxes, since much of the spending would be directed to goods and services produced elsewhere. In addition, there are typically constraints on subcentral governments that severely limit their capacity to engage in deficit spending on the current account. Central government fiscal measures, automatic as well as discretionary, are clearly better suited to countercyclical finance.

Economists have also explored the constraints on subcentral governments regarding redistributive measures, suggesting that the central government must play a primary role in support for low-income households. A local government that initiates an aggressive program to redistribute income from high-income households to the poor incurs the risk of attracting an inflow of low-income residents while encouraging an outmigration of the wealthy who must finance the program. It is straightforward to show in principle that such decentralized programs of poor relief are likely to result in inefficiently low levels of payments to the poor (Brown and Oates 1987). Moreover, there is evidence suggesting that this contention has some force. In a recent and careful empirical study, Jonah Gelbach (2002) has assembled and analyzed the

individual migration behavior of a large sample (over 100,000) of female-headed households on welfare in the United States. Gelbach finds significant migration effects in response to benefit differentials and, in addition, evidence that this migration induced substantial cuts in the levels of benefit payments. In the absence of outright restrictions on mobility, there thus seems to be a strong case for the central government to take an active role in poor relief.

The case for decentralized government finance rests in the provision of goods and services whose consumption is limited to specific jurisdictions. In this setting, decentralized provision allows each jurisdiction to provide levels of public outputs that are responsive to the preferences, costs, and other circumstances peculiar to the jurisdiction. It is straightforward to show that such a set of differentiated outputs will increase economic welfare relative to an outcome characterized by a more uniform level of provision across the nation.<sup>1</sup> The basic prescription emerging from this perspective is that the central government should provide «national public goods» that are consumed collectively by everyone in the nation, while state (or provincial) and local governments should provide those public services whose consumption is specific to residents of their own jurisdictions.

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<sup>1</sup>This proposition has been formalized as the «Decentralization Theorem» (Oates 1972). The magnitude of the welfare gains from such decentralization depends on several factors including the variation in demands across jurisdictions, jurisdictional cost differences, and the price elasticity of demand (Oates 1997).

As an alternative to this prescription, we could imagine a setting in which the central government, possessing complete information on preferences and costs, provided an efficient pattern of differentiated outputs across jurisdictions; this would effectively mimic the decentralized solution. But such an outcome is unlikely for at least two reasons. First, there are formidable information problems. It is hard for a central agency to know what people want in each locality and the precise circumstances (including costs of provision). Decentralization takes advantage of the more complete information that is available in each jurisdiction. Second, there is typically a political obstacle to the centralized provision of differentiated outputs. There are pervasive political pressures for equality of treatment that make it hard to provide a wider scope of services in some areas than others (even though it is economically efficient). The centralized provision of many public services is likely to compromise the performance of the public sector.<sup>2</sup>

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<sup>2</sup>This is admittedly a simplified treatment of what is a rich problem. Asymmetric information and principal-agent relationships introduce intriguing and important issues of coordination. See, for example, Rosella Levaggi's (2002) insightful treatment of decentralized budgeting procedures. See also Cremer et al. (1997).

Let me offer two brief observations on this economic prescription for the assignment of functions. First, this is not a rigid prescription. There is clearly some scope, if limited, for decentralized stabilization and redistributive activity. In particular, there are often constructive opportunities for cooperative programs which make use of lower level governments in the implementation of general, national programs. The key point here is that a major central presence seems to be needed for these two functions. Second, the general principle for the provision of goods and services does not translate easily and directly into a precise delineation of outputs to be provided at each level of government. What is taken to be "local" in some countries or settings may not be so regarded elsewhere.<sup>3</sup> But there remains a strong case on efficiency grounds (in the absence of important economies of scale) for the provision of public services at the lowest level of government which encompasses spatially the benefits and costs of the outputs.<sup>4</sup>

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<sup>3</sup>Anwar Shah (1994, ch. 1) and Ronald McKinnon and Thomas Nechyba (1997) provide useful listings of public services associated with different levels of government.

<sup>4</sup>This general prescription has been challenged in certain parts of the now enormous literature on fiscal competition. The claim in certain strands of this literature is that governments, in their eagerness to attract new investment and create jobs, will hold down tax rates and costly regulatory measures and engage in a so-called «race to the bottom.» The result will be a general underprovision of public services, unless there is some kind of centralization or harmonization of fiscal and regulatory measures. This literature goes beyond the scope of this paper. But let me simply note that this is a diverse literature with sharply contrasting findings. Depending on the specific model and on one's view of public-sector behavior, fiscal and regulatory competition can also result in Pareto-efficient levels of public outputs, or, in the case of Leviathan behavior, can constructively constrain the overly expansive tendencies of the public sector. Moreover, there is not much empirical support for the race to the bottom; in fact, most of the empirical work on this issue (and there isn't much) finds little evidence of such behavior. Finally, Ian Parry (2001), making use of a computational general-equilibrium model, finds that the likely distortions (if any) from tax competition are likely to be quite modest in magnitude. For surveys and assessments of this literature, see, for example Oates (2001a, 2002) and Wilson (1999). Dietmar Wellisch (2000) provides a comprehensive treatment of the theory of economic

## 2. On the Assignment of Functions and European Union

As mentioned earlier, the literature on fiscal federalism takes its setting (for the most part) as the modern nation-state with a strong and sizeable central government. The new top-layer (or central) government in the European Union doesn't fit this model well. It is much more limited in power and in budgetary size than the central government in a typical nation-state. Indeed, most observers see the upper-tier budget, at least in the relatively short run, as accounting for, perhaps, something like two percent of European GDP. And this has some important implications for the assignment of functions.

Let me acknowledge at the outset that the application of the fiscal-federalism literature to the analysis of the emerging European Community has a long history. Indeed, several of us were involved in such initial explorations some twenty-five years ago under the auspices of the «Commission of the European Communities» (1977) with the resulting «MacDougall Report.» Thus, the issues I discuss in this section are by no means new ones; at the same time, they have not, in my view, really been resolved.

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competition among governments in his excellent and recent book.



The fiscal-federalism literature contends that the central government must assume the primary responsibility for the macro-economic stabilization function. Does this prescription make sense in the context of European Union? For those countries which have joined in monetary union, there is now a central bank with powers to regulate the supply of money and credit. But when we turn to fiscal policy, it seems clear that the upper tier cannot perform the fiscal stabilizing function of the central government in the typical nation-state. In the latter case, the central budget typically exhibits a significant level of automatic stabilization, as tax revenues and transfer payments respond quickly and spontaneously to changes in the state of the national economy. The relatively small budget of the upper tier in Europe severely limits its macroeconomic impact both in terms of automatic stabilizing forces and discretionary measures. This might not be a serious problem if the member nations were in a position to perform this function. But the fiscal limitations (including debt and other constraints) on their budgetary activities seriously restrict their scope of action. It is unclear, for example, how a member country will be able to address a country-specific shock to its national economy. In this respect, the member countries become much like the states in the United States with only a very limited capacity to redress the ups and downs in aggregate levels of economic activity (Inman and Rubinfeld 1994). European economists are obviously aware of, and at work on, this issue. For example, in its report on «Stable Money–Sound Finances,» the Commission of the European Communities (1993) explicitly acknowledges this problem and explores some alternative Community instruments to assist with regional stabilization. But the issue remains: the new European public sector may not be well suited to performing the macroeconomic stabilization

function.<sup>5</sup>

The literature, as we have discussed, also suggests a major role for the central government in redistributive measures to assist the poor. Here again, the limited size and scope of the upper tier budget puts this function largely outside its sphere. The sense is that these programs will remain primarily the responsibility of the member nations. But as Hans-Werner Sinn (1994, 1997) and others have argued, growing fiscal competition and increased mobility across national borders may result in serious constraints on redistributive programs in individual nations. In the limiting case, Sinn (1994) points out that fiscal competition will result «...in an equilibrium where only benefit taxes are charged, and no redistributive policies are carried out» (p. 100). This is admittedly an extreme case. There is clearly some scope for country redistributive measures in Europe, but it may diminish over time. In a provocative empirical study of the U.S. experience, Martin Feldstein and Marian Vaillant Wrobel (1998) have found that state and local governments cannot systematically redistribute income; their analysis finds that measures seeking to equalize income at the state level are completely undone (and in a relatively short time) by responses of mobile labor and capital. At any rate, there seems to be real grounds for concern over the capacity of the emerging European public sector to perform Richard Musgrave's Distribution Function.

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<sup>5</sup>Of course, one can argue that traditional fiscal stabilization measures are relatively ineffective (especially in a political context)—and that an appropriate centralized monetary policy is all that is required. But this is a contentious issue.

### 3. Fiscal Institutions and the «Hard Budget Constraint»

In addition to a proper alignment of functions among levels of government, a high level of public-sector performance requires the design and establishment of a set of fiscal and regulatory institutions that provide the right kinds of incentives for public decision-making (e.g., Picciotto and Weisner 1998). A central theme in this literature has been the need for a «hard budget constraint» at all levels of government, but especially at decentralized levels (e.g., McKinnon 1997). Indeed, attempts around the world at fiscal decentralization have often been bedeviled by fiscal institutions that have effectively provided budgetary bailouts for politicians at provincial and local levels. In short, fiscal decentralization cannot proceed by simply dumping monies on existing or newly formed provincial and local governments: appropriate procedures and institutions must provide fiscal discipline in a form that encourages efficient budgetary decisions.<sup>6</sup> In this section, I want to explore briefly the implications of hard budget constraints for the structure of tax, intergovernmental grant, and public debt programs.

The basic idea is simply that fiscal institutions should induce the electorate and their officials to weigh the benefits of prospective public programs against their costs. And this implies that provincial and local governments must bear the costs (at least at the margin) of public

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<sup>6</sup>In the absence of fiscal institutions that provide such discipline, excessive spending by provincial and local governments resulting in bailouts by the central government can create a serious moral-hazard problem and even destabilize the entire public sector. There are numerous instances of this phenomenon including, for example, recent experience in Argentina and Mexico (Trillo et al. 2002).

expenditures; they must finance these programs through user fees or jurisdictional taxes. They cannot expect that decisions to expand public spending will be later ratified by increased financial assistance from elsewhere. As someone suggested to me recently, there should be «No representation without taxation!»

This assuredly does not rule out systems of intergovernmental grants, perhaps with equalizing features. But it does imply certain properties of a grant system. First, the magnitude of such grants in state and local finance cannot be too large. I know of no magical number here, but if intergovernmental transfers dominate provincial and local revenue systems, then officials are likely to turn to political channels to get additional funding from above, instead of relying on increases in own revenues.<sup>7</sup> Second, intergovernmental grants (aside from special programs with external effects) should be lump-sum in character so that provincial and state governments must finance at the margin extensions of public programs. There must be no expectation that decisions to expand provincial or local expenditures will be financed by increased transfers from above.

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<sup>7</sup>In the United States, there is a large body of empirical work that has found that intergovernmental grants have provided a powerful stimulus to spending by state and local governments; this impact is known as the «flypaper effect.» In a similar spirit, Stanley Winer (1983) has found in Canada that the separation of public spending and tax decisions through intergovernmental grants raised provincial spending.

This view also has important implications for the use of debt finance. There is a proper and useful role for the issuance of debt by state and local governments: it provides a sensible and equitable way to spread out the payments for public infrastructure over the useful life of such projects. But debt finance is inappropriate for financing deficits on current account. It effectively provides a way for current decision-makers to push the costs of public programs onto later generations.<sup>8</sup> Thus, it is important that provincial and local governments be constrained in their use of debt issues to finance only capital projects.

Moreover, as Ronald McKinnon (1997) has stressed, public borrowing by provincial and local governments should take place in private capital markets, not through publicly-owned banks. In the U.S., state and local governments have historically had to compete for borrowed funds in regular capital markets. This in itself imposes a kind of fiscal discipline in that state and local bond issues become subject to ratings for risk and reliability alongside private-sector borrowers. In contrast, where such governments can simply turn to public banks to absorb their bond issues, debt finance provides an easy out for meeting budgetary shortfalls.<sup>9</sup>

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<sup>8</sup>This need not be true, incidentally, if outstanding debt liabilities are capitalized into local property values (e.g., Oates, 1972, ch. 4).

<sup>9</sup>This admittedly can be a more complex issue in developing countries where well developed private capital markets may not exist. But it remains an important principle nevertheless.

The implication of all this is that decentralized levels of government need to have significant and efficient systems of own-taxes to finance a major portion of their budgets.<sup>10</sup> This is, in my view, perhaps the most pressing issue facing efforts at fiscal decentralization, especially in the developing countries. Public sectors in the developing world are not only highly centralized (relative to the industrialized nations) but they place a disproportionate reliance on central revenues. Intergovernmental grants are often the major source of revenues for provincial and local governments; this is a formidable obstacle to the development of effective and accountable public decision-making.

In many of the industrialized nations, the past century or two have been a period of increased fiscal centralization. The point of departure for this centralizing trend (in the United States, for example) was a setting with a relatively well developed system of state and local taxation. In sharp contrast, the starting point for many of the developing countries is a highly centralized system of public finance with very limited and weak institutions of local taxation. It will be very difficult to establish meaningful fiscal decentralization without the introduction of effective systems of local taxation (Oates 1993; Bird and Vaillancourt 1998). This issue is also of relevance in certain European nations (especially some of the prospective members of European Union), where moves toward fiscal decentralization have encountered serious problems in the

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<sup>10</sup>One could, in principle, envision a system with hard budget constraints for local government in which all local revenues came from the central government in the form of outright grants or, perhaps, some form of revenue sharing. The idea is that the sums received would be absolutely fixed in magnitude, which would, in turn, fix the size of the local public budget. Local government would thus face a hard budget constraint in the sense that any extensions of spending for one program would have to be financed by a cut in other programs. The problem here, of course, is that there is no mechanism to adjust the size of the budget in cases where expanded (or contracted) programs overall would be beneficial.

formation of good systems of provincial and local taxation.<sup>11</sup>

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<sup>11</sup>There is an extensive literature on taxation in a federal system that addresses to so-called «tax-assignment problem,» the issue of which taxes are best assigned to the different levels of government (McLure 1983, Oates 1999).

Let me offer one specific observation on the issue of local taxation. In some of the industrialized countries (especially the United States), the primary source of own-tax revenues for local government has been the property tax. I have come to see this as quite a good local tax for a couple of reasons. First, since many of the benefits from local programs accrue to local landowners, the local property tax can, under certain conditions, approximate a benefit tax—which makes it an appealing fiscal instrument for encouraging efficient local decision-making. Second, it is a tax that is not used by other levels of government in the U.S. It satisfies to so-called «separation of sources» principle under which each level of government has its own distinct source of revenue. As such, the local property tax becomes transparent in the sense that local residents can associate their local tax payments directly with the local public services that they receive. This again promotes local accountability and efficient local choices. The tax admittedly requires its own administrative apparatus with the associated costs, but I think it is probably worth it.<sup>12</sup> At the same time, there are certainly other taxes as well that are workable at the local level.

#### 4. Corruption and Multi-Level Governance

A new and intriguing literature has taken up the relationship of corruption («the misuse of public office for private gain») to the vertical structure of the public sector. Some have argued (e.g., Jan Brueckner 1999) that local government is especially prone to corruption with the implication that fiscal decentralization may result in a more corrupt public sector overall, but the

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<sup>12</sup>For a collection of papers by a variety of authors that explores property taxation in the context of local government finance, both in conceptual and empirical terms, see Oates (2001b).



case has been argued both ways. This issue has been the subject of both some recent theoretical and empirical work. In a theoretical study, Pranab Bardham and Dilip Mookherjee (2000) construct a formal model that embodies «capture» by dominant groups at different levels of government. Their model suggests that, depending upon the particular circumstances, capture may be either more or less pervasive at the central, than at the local, level. They conclude that «...the extent of relative capture may be context-specific and needs to be assessed empirically» (p. 135).

It thus seems hard to reach firm conclusions on this matter on purely theoretical grounds. But there is some provocative empirical work. In an early study, Jeff Huther and Anwar Shah (1998) constructed a wide-ranging set of measures of «good governance» which they then compared with (among other things) the extent of fiscal decentralization for a cross-country sample. They found that most of their good-governance measures (including an index of corruption) exhibited a significant positive correlation with the extent of fiscal decentralization suggesting that decentralization reduces corruption in the public sector. While this is an interesting finding, it is hardly conclusive since the analysis does not control for the influence of other factors on the quality of governance. In particular, fiscal decentralization is highly correlated with other economic and political variables including the level of income. High-income nations, which typically get relatively high marks for good governance, also tend to be relatively decentralized in fiscal terms. In fact, Roy Bahl and Johannes Linn (1992) have argued that «Decentralization more likely comes with the achievement of a higher stage of economic development» (p. 391). It is difficult to sort out cause from effect here.

Some more recent work has addressed this issue. In one such study, Raymond Fisman and

Roberta Gatti (2002) have estimated a multiple-regression model in which they examine the relationship between fiscal decentralization and corruption in a setting that allows for the effects of a number of other important variables. The dependent variable in their analysis is a measure (in fact, three different measures) of corruption. They regress their indexes of corruption on a set of independent variables that includes not only a variable measuring fiscal decentralization (the subnational share of public expenditure), but also measures of income, population size, openness, and some political variables. Their findings indicate that the level of corruption varies negatively and significantly with the extent of fiscal decentralization. The results seem robust and, moreover, the magnitude of the effect is substantial.<sup>13</sup>

This work is admittedly only a first cut at what is a complex issue. In addition, its applicability to the emerging European Union is far from clear. But it does raise the intriguing and important question of how the restructuring of the public sector in Europe will affect the extent of corruption (or, perhaps, a better term here is «capture» by dominant groups) in public decision-making. This may have much to do with the specific form of the new constitution. It is certainly not clear in this respect that increased centralization will necessarily lead to higher levels of «integrity» in public policy-making.

## 5. Concluding Remarks

The evolving public sector in Europe is subject to two sharply contrasting forces:

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<sup>13</sup>In another cross-sectional study of corruption, Treisman (forthcoming) finds that the extent of corruption (after controlling for other determinants) is, on average, higher in countries that are «federal states.» It is not fully clear, however, how we should interpret the dummy variable for a federal country relative to measures of fiscal decentralization.

centralization in the form of a new top (or central) level of government and decentralization in the form of devolution of fiscal and other powers in several member countries to regional and local governments. This implies, virtually by definition, a reduced role for national governments in Europe. And this raises the intriguing and important question of the economic implications of this evolution for the performance of the public sector.

The traditional «model» of fiscal federalism suggests an important role for national government in undertaking basic responsibility for macroeconomic stabilization and certain redistributive functions. As we have seen, it is unclear whether the new government sector will be suitably equipped to meet these responsibilities. In particular, it does not appear the new top tier has the capacity to perform these tasks—nor, perhaps, may the member states. At any rate, these are issues that deserve close attention.

More generally, federal fiscal structure needs to be seen as an integrated whole with the design of the system following the assignment of functions and incorporating intergovernmental transfers, a set of tax instruments, and borrowing practices that impose incentives for efficient and equitable fiscal decisions. These institutions must confront decision-makers with hard budget constraints so that they explicitly face up to the costs of the programs they initiate. This is admittedly far easier said than done in a political setting, but there are, as we have discussed, some useful and important guidelines to assist in the process.

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How are European countries and their regions organised in fiscal and budgetary terms? What lessons can the EU draw from its own fiscal past and from that of its Member States? Over and above the originality of the answers provided by the authors, the book suggests that it would be difficult to take the integration process further without first clarifying what Europe can, should or wants to do. The book tackles a key issue for the European Union: Fiscal Federalism. It evaluates the applicability of this theoretical perspective for the EU. Conversely, it pinpoints ways in which the diversity of existing fiscal settings and organisations, both at national and European levels, can throw light on the theory. Fiscal federalism and decentralization. 12,224 Followers. Recent papers in Fiscal federalism and decentralization. Papers. People. Federalism is a form of state in which the component provinces and units under a political organization take part by sharing powers and functions through cooperative manners despite of having ethnic pluralism and cultural diversities. more. The article ends providing some conclusions and reflections from a comparative perspective on the European integration process. Save to Library. Download. As a subfield of public economics, fiscal federalism is concerned with "understanding which functions and instruments are best centralized and which are best placed in the sphere of decentralized levels of government" (Oates, 1999). In other words, it is the study of how competencies (expenditure side) and fiscal instruments (revenue side) are allocated across different (vertical) layers of the administration. An important part of its subject matter is the system of transfer payments or grants by

In this paper, we compare the present process of definition and implementation of fiscal policies in the European Union with the main conclusions of the "fiscal federalism" theory. This is done in order to draw possible lessons for future evolution, particularly taking into account the possibility of creating a European "Federation of Nation-States", which we supported in a previous work. In this context, we argue for several important lines of change in the short-run, namely an effective change in the process of coordinating fiscal policies and a credible reform of the Stability and Growth Pact, and in the medium-long-run, namely an important increase in the size of the European budget. Suggested Citation. Rui Henrique Alves & "scar Afonso, 2007. Fiscal federalism, financial relations between units of governments in a federal government system. Fiscal federalism is part of broader public finance discipline. The term was introduced by the German-born American economist Richard Musgrave in 1959. Fiscal federalism deals with the division of. Fiscal federalism, financial relations between units of governments in a federal government system. Fiscal federalism is part of broader public finance discipline. The term was introduced by the German-born American economist Richard Musgrave in 1959. Fiscal federalism deals with the division of governmental functions and financial relations among levels of government.