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Theories of Fiscal Federalism and the European Experience

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ABSTRACT

In the European experience it appears to be a significant deviation from Oates's theoretical model since the Maastricht Treaty has not assumed as necessary to transfer the direct management of stabilization policy to the supranational level. Stabilization policy is in fact managed by member-states, although its coordination is to be ensured at supranational level.

In the field of redistribution, the European level must undertake territorial redistribution so that equalizing transfers ensure that all areas of the European Union offer equal opportunities and certain basic services are furnished uniformly. The member-states and local communities, for their part, must maintain their responsibilities for the management of social policy and the redistribution of personal income – according to the preferences of each community – while averting the perverse effects in terms of mobility envisaged by the theoretical model of fiscal federalism..

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1 THE CLASSICAL MODEL OF FISCAL FEDERALISM

Within the global field of public finance, fiscal federalism addresses the vertical structure of public sector, and the model to which the literature refers is that built initially by Musgrave (1959) and then developed by Oates (1972). In this model the economic functions are assigned to the different levels of government according to a scheme where the central government has basic responsibility for macroeconomic stabilization and for income redistribution. In addition to these functions, the central government provides goods and services consumed by the entire population, while local governments provide goods and services whose consumption is limited to their own population. These conclusions follow from some very simple assumptions :

- a. the redistribution function should be centralized because the mobility of persons – which increases as the size of the territorial area diminishes – may cause locally implemented redistribution policies to fail. In fact, any jurisdiction which unilaterally imposes higher taxes on the rich encourages the loss of mobile resources, including both capital and high-income residents. Alternatively, jurisdictions which unilaterally offer large subsidies to the poor will attract outsiders to share the benefits. Consequently, where the intention is to adopt a strongly redistributive policy, the financial resources will be lacking because expenditure is very high and the tax base has shrunk, while in the other areas the budget will show a substantial surplus because the tax base has expanded;
- b. the stabilization function should also be centrally managed. The reason in this case is the greater effectiveness of fiscal policy, which depends on the propensity to import and, therefore, on the level of the multiplier. Lower levels of government are more open to trade. Consequently, expenditure remaining equal, a larger amount of benefits in terms of income and employment will arise outside the territorial area in which the resources necessary to finance expansionary policy have been collected. In the presence of strong positive externalities, the supply of the public good ‘stabilization’ may therefore be sub-optimal;
- c. only the allocative function should be distributed geographically, because the task of supplying public goods should be assigned to the level of government within whose territory the majority of the benefits of spending occur. Hence, the production of local public goods should be undertaken by the lower levels of government, in that “a varied pattern of local outputs in accordance with local tastes will be Pareto superior to an outcome characterized by a centrally determined, uniform level of output across all jurisdictions” (Oates 2005, 353).

This proposition, well known as the Decentralization Theorem, correctly recognizes that output of some local public goods can produce interjurisdictional spillover benefits, i.e. benefits for residents in other jurisdictions. If these external effects are limited, they could be internalized, according to the traditional Pigouvian theory, through subsidies provided by a higher level of government. However, when public services are pure public goods for which the marginal cost of adding another user will be zero, or when external benefits are large or the benefits extend nationwide, the production of public goods becomes a task of the central government since a decentralized production of these goods, characterized by large positive externalities across jurisdictions, will yield a sub-optimal level of output.

The Decentralization Theorem assumes that the alternative to the local provision of public goods is a centrally-determined uniform level of public output. This assumption is based on two arguments: the first is that local governments are closer to their constituencies, and therefore have more in-depth knowledge of the local preferences. Instead, it is difficult for the central government to determine the different preferences of all the jurisdictions. The second argument is that there is a political constraint – the need to avoid any discrimination between different local or regional authorities – which induces the central level of government to provide a uniform level of output to all the local units.

A further argument in support of the assignment of the allocation function to the local authorities as far as the provision of local public goods is concerned is linked to the well-known Tiebout (1956) model, in which households are assumed to be freely mobile. They shop among local jurisdictions and select the community of residence which offers their preferred package of local public goods, taxes, and regulations. In this institutional structure, if any jurisdiction were to provide public services inefficiently, households would move to another jurisdiction. Tiebout's competition then produces a Pareto-efficient outcome since people sort themselves into groups that are homogenous in their demands for local services. As the Decentralization Theorem clearly shows, the more homogenous local jurisdictions are in their demands, and the greater the variation in these demands across local jurisdictions, the larger the welfare gains from decentralization. Hence the Tiebout argument strengthens the validity of the Oates model.

According to Oates, therefore, there are solid economic reasons for preferring a federal structure of the state. This structure, in fact, is optimal not only because of the political benefits that it brings by guaranteeing greater democracy through the creation of a pluralist, and therefore competitive, system, but it is so also from an economic point of view (Breton and Scott 1978) in that it complies with Wheare's (1963, 10) recommendation that "by the

federal principle I mean the method of dividing powers so that the general and regional government are each, within a sphere, co-ordinate and independent”.

Wheare’s institutional vision must be kept in mind if the optimal economic Constitution is to be defined, since, according to Oates, a federal model guarantees effective coordination, and therefore unity, as far as stabilization and redistribution policies are concerned, and the independence of the various tiers of government in the allocation branch of the government. In this regard, territorial differentiation in the production of public goods is the necessary condition for the maximising of social welfare.

2 THE FINANCING OF LOCAL GOVERNMENTS WITH OWN RESOURCES AND INTERGOVERNMENTAL TRANSFERS

The principle of fiscal equivalence implies that, within a given jurisdiction, the costs of providing public goods should be covered by those that enjoy their benefits. This prompts the question known in the literature as the ‘tax assignment problem’ (McLure 1983): what are the taxes best suited to financing the different levels of government?

The idea in the mainstream literature is generally that benefit taxation should be the rule at the local level. This implies that local governments should rely mainly on property taxation and users fees, while the use of redistributive taxes - like the progressive income tax - should be assigned to the central level of government. An important corollary to this contention concerns environmental taxes (Brosio 2006). If the tax base is related to the territory, or land use, the tax should be assigned to the local level. A relevant example is road pricing. Taxing the use of roads is a kind of benefit taxation because the environmental benefits (less congestion, less pollution) are mainly enjoyed by residents in the area. Energy taxation could be established at the central level, since the benefits (less emissions of greenhouse gases, less acidification) are enjoyed by everybody, while an additional local tax on the same tax basis is likewise justified since local pollution diminishes.

Here, the main concern regards the possible distortions due to the decentralized taxation of mobile tax bases. Local governments operate in settings where economic units are able to move rather freely among jurisdictions. Hence, taxes may give rise to distortions in resource allocation. If capital - which is quite mobile - is taxed at the local level, the outcome may be capital outflows and the inefficient location of this production factor. As Oates stresses, this does not mean that mobile units should not be taxed at the local

level, but “that on efficiency grounds decentralized governments should tax mobile economic units with benefit levies” (Oates 1999, 1125).

Reliance on benefit taxes at the local level does not exclude the use of intergovernmental transfers. These are justified for at least three reasons. The first of them is the existence of benefits external to the jurisdiction. If these are not internalized, the production of public goods will be sub-optimal. The second is that fiscal equalization across jurisdictions is necessary to reduce excessive differences in per capita income among different areas. Given the same fiscal effort, the jurisdiction where the level of per capita income is higher will be preferred both by the rich and the poor because the revenue from local taxes, and therefore the output of public goods, will be higher. Horizontal equity is violated since households are treated differently according to their location or residence (Boadway 2006). A lump-sum grant from the central to the regional or local government is therefore justified on both equity and efficiency grounds, for otherwise the gap between the level of economic activity in the poor jurisdiction and the national average will constantly widen. The third reason is that there is no perfect correspondence between expenditures and revenues raised at the different levels of government, and this disequilibrium must be covered by a transfer of resources from the central government to the local ones.

Grants may be either conditional, with restrictions on their use by the recipient, or unconditional, so that they can be used for any purpose. Conditional grants should be utilised in the form of matching grants to internalize benefits engendered for residents of other jurisdictions, when the grantor guarantees a certain share of the expenditure. This is a sort of Pigouvian subsidy whose purpose is to incorporate external benefits into the economic calculations of the decision maker; and the matching rate should reflect the extent of the spillovers.

Unconditional grants are normally used for fiscal equalization on the basis of an equalization formula related to the fiscal need or the fiscal capacity of the recipient jurisdiction. In the absence of such grants, the gap between rich and poor jurisdictions will widen, whilst grants could produce a more level playing field. But the primary justification for fiscal equalization is still the one based not on efficiency, but on equity grounds. According to Oates (1999, 1128) “the prescriptive theory of intergovernmental grants thus leads to a vision of a system in which there exists a set of open-ended matching grants, where the matching rates reflect the extent of benefit spillovers across jurisdictional boundaries, and a set of unconditional grants for revenue sharing and, perhaps, equalization purposes”.

Local governments could be funded through revenue sharing as well. This implies that the central government collects taxes whose revenue is in turn redistributed to the local or regional levels. There is a large body of evidence

that regional and local taxes are normally more regressive than the central ones, and this justifies the collection of national taxes and their redistribution to the lower tiers of government. Furthermore, if the administration of local taxes is inefficient, it makes sense for central government to collect tax revenues for, and then transfer grants revenue to, regional and local governments. To avoid the risk that moral hazards generate inefficient behaviours by local governments – which view such transfers as ‘blank checks’ issued by the central government – they should be linked to the rates of taxes determined by local authorities.

3 THE NEW THEORY OF FISCAL FEDERALISM

A different view of fiscal federalism has been pioneered in the literature by Brennan and Buchanan (1980) and Breton (1998). It envisions the public sector as a Leviathan whose main goal is to maximize the revenues extracted from the economy. From this perspective, decentralization is device to restrict the expansionary tendencies of the government. Competition among local authorities can limit the capacity of a monopolistic central government to increase its control over the economy’s resources and “offer partial or possibly complete substitutes for explicit fiscal constraint on the taxing power” (Brennan and Buchanan 1980, 184).

According to the 'Public Choice approach', a decentralized system produces, through competition, control over decision-makers (Breton 2006). This is because when the citizens of one jurisdiction appraise the performance of their government by comparing it with the performance elsewhere but at the same jurisdictional level, they will induce their government to behave as well as (or better than) the other ones in terms “of levels and qualities of services, of levels of taxes or more general economic and social indicators” (Salmon 1987, 32).

This is a controversial issue with regard to the European experience, because the Treaty of Maastricht does not consider fiscal competition to be a mechanism adequate to control the gap between revenues and expenditures at the level of member-states joining the Monetary Union, and it has set an explicit limit in order to prevent any excessive deficits. Whilst some States have been explicitly in favour of fiscal competition among the different member-states, the prevailing view has been that the risks of a ‘race to the bottom’ engendered by fiscal competition should be avoided by adopting a cooperative approach.

In an important survey of new theories on fiscal federalism, Inman and Rubinfeld (1997, 47) remark that “for most economists, the principle of

economic federalism, with its recommended institutions of competitive decentralized local governments and a strong central government to provide pure public goods and control intercommunity externalities, essentially defines what federalism is about. However, the principle has had only mixed success as a guide to economic policy. Its strength has been to articulate how fiscal competition among decentralized local governments can ensure the efficient provision of congestible public services; several recent studies offer empirical support for the proposition that competitive local governments do provide citizens the public services they want at the lowest cost”.

On the other hand, cooperative federalism assigns all public goods and the control of intercommunity externalities locally, unless local governments voluntarily agree to do so centrally. But even agreements among few jurisdictions often fail to achieve fully efficient outcomes, and the macro-management of the economy can also be regarded as the response of the central government to a failure of Coasian bargaining among the local authorities. With reference to the European experience, Collignon (2003, 108) shows the conditions necessary for member-state governments to voluntarily co-operate in order to supply European collective goods: “1) if the benefits for one government are less than the total cost of providing the European good, there is a rational incentive to this government not to participate in the EU's provision of the collective good and to 'free ride'; 2) the larger the number of the EU member-states, the less likely they are in providing the collective goods”.

Finally, Inman and Rubinfeld define democratic federalism as a system that “unlike economic federalism does not implicitly assume that the central government will provide public goods and regulate interjurisdictional spillovers efficiently. In contrast to cooperative federalism, only majority-rule – not unanimity – is required to make a decision. Democratic federalism seeks to balance the potential efficiency gains of greater centralization in a world of local spillovers and pure public goods against the inefficiencies which might arise when a central legislature sets policies” (Inman and Rubinfeld 1997, 51). Close account should be taken of this approach in the ongoing discussions on the new Lisbon Treaty and the development of fiscal federalism in the perspective of a European Constitution (Collignon 2003).

4 THE DISTINCTIVENESS OF THE EUROPEAN EXPERIENCE

Assessment of the prospects for European fiscal federalism must start from the premise that Europe is at present undergoing two simultaneous institutional changes: on the one hand, an upward devolution of powers from member-states to the European Union; on the other, a downward transfer of powers from states to local governments. The current political debate does not generally take account of this simultaneity, and the two processes are studied separately. In particular, whilst close consideration is made of the increasing decentralization of government functions, insufficient examination is made of the new constraints – and the new opportunities – that membership of the European Union entails for all lower levels of government.

The decentralization of functions from the central state to local government is a process ongoing in almost all the member-states of the European Union: new competences are attributed to infra-state levels (Breton and Frascini 2003), and in parallel, albeit in different ways according to the country, the resources necessary to meet spending requirements are transferred. At the same time, apparent at European level is a model of fiscal federalism which reflects the classic definition by Oates (1999), but with original features connected with the distinctive experience of the European Union.

As a matter of fact the Musgrave-Oates theoretical model is contradicted by the current distribution of functions within the European Union (Tabellini 2001) in two main respects:

- a. redistribution policy is, and presumably will remain at least in the foreseeable future, assigned to the national level, not to the Union. Since Pauly's (1973) celebrated essay on redistribution as a local public good, the literature has put forward various theoretical reasons for this choice, which seems necessary in Europe given the marked differences that persist at national level in social preference functions concerning the optimum level of redistribution;
- b. but stabilization policy, too, is predominantly assigned to the national level. It is true that the management of monetary policy has by now been transferred to the European level, but the Treaty of Maastricht gives the European Central Bank solely the task of ensuring price stability, whilst in regard to stabilization policy the Treaty merely states that this must be pursued through the coordination of national policies.

The building of Europe is a process in constant evolution. Hence it may happen that this allocation of functions will change over time. It is possible that the European experience may generate a new model for the assignment of

governmental economic functions: one which is more federalist, and which grants a greater role to the lower levels of government in regard to redistribution and stabilization. Should this happen, it will obviously be necessary, on the one hand, to strengthen the decision-making capacity of the European institutions, and on the other, to introduce mechanisms for effective coordination not only between the European Union and the member-states, but also with regional and local governments.

As regards stabilization policy, the Oates model envisages that this function should be undertaken at the supranational European level, for a stabilization policy managed at national level is largely ineffective, given the macroeconomic externalities that it produces. Indeed, since the creation of the monetary union, currency management has been assigned to the European level of government. But national fiscal policy, too, is already subject to numerous restrictions. Firstly, owing to the constraints of Europe-level fiscal harmonization, taxes cannot be freely varied. Secondly, as regards public spending, its expansionary effects tend largely to be transferred to the other member countries, given the extent of interdependence now achieved. Thirdly, budget balances are conditioned by the Maastricht constraints and the rules set out in the Stability Pact, which significantly condition the flexibility of fiscal policy at the member-state level.

It follows from these remarks that stabilization policy should necessarily be transferred to the European level, and the literature puts forward various arguments in support of this conclusion. Firstly, national governments are prepared to produce an amount of the public good 'stabilization' which falls short of that deemed optimal by the European Union, because stabilization policies tend to exert their effects in the other countries belonging to the Union. Secondly, in the event of asymmetric shocks, automatic stabilization is excessive, and therefore more deflationary than necessary, because it does not take account of the negative external effects that it generates.

A second reason for assignment of stabilization policy to the European level concerns the operation of Ricardian equivalence. In this case, agents anticipate the effects of intertemporal stabilization on their tax liabilities, thereby dampening the impact on aggregate expenditure of variations in the net balance of taxes and transfers. Bayoumi and Masson (1998) have shown that, in Canada, the impact of a deficit in the provincial budget on consumption within the province is only equal to between one-third and one-half of the expansionary effect of an equivalent federal deficit in the same province. Finally, also the mobility of tax bases within a monetary union may reduce the effectiveness of a stabilization policy at regional level (Torres and Giavazzi 1993).

5 THE COORDINATION OF FISCAL POLICIES

The debate about stabilization policy within Europe has produced important innovative ideas, especially in those countries where there is strong resistance against relinquishing national autonomy in the management of stabilization policy. In his discussion of whether responsibility for such policy should be transferred to Community level, Leefink (2000) concludes to the contrary, because the financial discipline imposed first by the Maastricht constraints and then by the Stability Pact have already significantly strengthened the effects of automatic stabilization. Consequently, in his view there is no convincing economic argument for strengthening the coordination of policies. Nevertheless, closer coordination of the economic policies of the member-states belonging to the monetary union has already been initiated by the Maastricht decisions intended to ensure a more effective stabilization policy.

As regards fiscal policy in particular, there are two main arguments in support of coordination, and therefore against unrestrained fiscal competition among member-states. Firstly, in the presence of closer integration among member countries, and especially greater mobility of the factors, fiscal competition may progressively reduce tax rates, with the consequent impossibility of financing a level of public spending deemed desirable. The coordination of fiscal policies, with rates sufficiently high to generate the requisite tax yield, may therefore be the suitable arrangement. Likewise, whenever it seems possible to obtain increased efficiency through a common management of taxation, it is advisable to assign a proportion of the tax yield to European level, i.e. to create a system of revenue-sharing between the European Union and national governments.

The second argument in favour of coordination concerns the existence of externalities which render uncoordinated policies sub-optimal. In general, this may happen if the benefits of public spending extend beyond national boundaries, if there are increasing returns to scale in the production of public services, or if fiscal policies have macroeconomic external effects. However, once the need for closer coordination of fiscal policies within the European Union has been recognized, the debate shifts to how such coordination can be achieved in practice (Masson 2000).

In general, three models of coordination are available. Firstly, the member countries may decide to harmonize their spending and taxation policies. There is already a notable level of VAT harmonization in Europe. By contrast, attempts to harmonize taxation on financial incomes have to date been unsuccessful, and there is scant coordination of social policies, despite the attempts recently made by the Luxembourg European Council. It seems unlikely that further

harmonization can be achieved without substantial institutional strengthening of the Union so that it is able to influence the decisions of member-states, also through the use of suitable financial incentives. A striking example is provided by the hitherto unsuccessful attempt to achieve the close harmonization of excise duties, in particular through the creation of a common system of energy taxation.

Secondly, it may be decided to launch a common action run directly by an European institution. In this case the coordination would very strong, and it would represent an important step towards creation of a system of fiscal federalism.

Thirdly, coordination may involve a mechanism of multilateral surveillance over national fiscal policies, although without binding constraints on the exercise of national sovereignty or a significant increase in the size of the European budget. Coordination would therefore result from a system of peer pressure. But there would be no guarantee that the final outcome would be any different from that forthcoming from an uncoordinated system.

As the institutional development of the European Union proceeds, it is likely that the three models of coordination will coexist until the final stage of a federal system has been reached: there will be harmonization in some areas, multilateral surveillance and peer pressure in others, and in yet others some embryonic form of fiscal federalism. The problem is determining in which of the traditional sectors of public finance – allocation of resources, stabilization, and redistribution of income – intervention through a European fiscal policy is necessary, given that there exist substantial externalities which, according to the subsidiarity principle, render national-level fiscal policies ineffective.

Approval of the Stability and Growth Pact has greatly restricted the scope for autonomous stabilization policy at national level if a country is hit by an exogenous asymmetric shock when it is already close to the deficit level set by the Pact. It has been proposed in the past that this limitation could be overcome by creating a European Unemployment Fund. First mooted in the MacDougall Report (European Commission 1977), this idea has been subsequently taken up by other authors with a view to introducing an automatic stabilizer at European level (Melitz and Vori 1992; for more critical treatment see von Hagen and Hammond 1997). It is true that, as for example Fatás and Mihov (1999) have shown, the volatility of output is lower in countries where the share of public spending in GDP is high, as in the European countries. Yet this argument does not seem decisive as regards stabilization, given that other authors have stressed that high public spending may have negative effects on development (Masson 2000), and that there is, moreover, strong political pressure to reduce expenditure to rebalance budgets structurally and thus comply with the constraints imposed by the Stability Pact.

6 THE MAASTRICHT MODEL

In the end, the Maastricht model (Treaty on European Union 1992) comprises significant innovations in the field of stabilization policy, but it also has a serious shortcoming. The model is important because it does not transfer stabilization policy in its entirety to the European level but leaves responsibility for it to national governments, merely stating that the European level should ensure the coordination of national economic policies. It thus seeks to avert the risk of asynchrony in stabilization policies – whereby one country adopts an expansionary policy while another country pursues a restrictive one – and uses the multilateral surveillance mechanism to steer national economic policies towards convergent objectives.

This therefore appears to be a significant deviation from Oates's theoretical model. The European experience does not deem it necessary to transfer the direct management of stabilization policy to the supranational level. Stabilization policy is in fact managed by member-states, although its coordination is to be ensured at supranational level. This provision means that “the budgeting may be done on a national and regional level, while the aggregate fiscal policy stance needs to be set at the European level” (Collignon 2003, 137). Yet there is a decisive shortcoming in the Maastricht model, and it consists in the fact that coordination must be ensured by the Council of Ministers, where decisions on fiscal policy are subject to the rule of unanimity. And this rule can guarantee neither the democracy nor the efficiency of decisions. Hence at European level also decisions on fiscal matters should be taken by majority vote in the future, and no longer unanimously, in accordance with the rules of democratic federalism. However, this outcome is still very distant, even after the innovations that should ensue from ratification of the Treaty of Lisbon.

If Europe is able to generalize the rule that decisions are taken by majority vote, important innovation may come about at European level in the management of stabilization policy, in that it will be predominantly managed by member-states through the coordination method, and coordination will be effective to the extent that majoritarian principle is applied. Also without direct intervention through the European budget, and therefore with the limited resources available at present, there will be neither the current time delays nor the current inefficiencies; and an embryonic common economic policy will finally be in place, rather than a mere sum of national policies. Obviously, once the federal stage has been reached, and when the European budget is of adequate size, European resources will efficaciously supplement national resources in the management of stabilization policy, thereby heightening its efficiency.

7 REDISTRIBUTION POLICY

With regard to redistribution, it is widespread within member-states but still limited at European level. The reason that it should be increased is the fact that fiscal capacity varies across countries owing to their different levels of per capita income. Consequently, in order to furnish the same level of services, governments must impose different tax rates, thereby favouring the mobility of factors for fiscal reasons, a system which is inefficient because it entails real costs in terms of resources. From this point of view, redistribution appears justified. Moreover, redistribution may serve the purpose of increasing solidarity among the countries belonging to the European Union, and thus promote further integration. However, from both these points of view there does not at present seem to be scope for increasing redistribution processes within the Union (Masson 2000).

Interpersonal income redistribution did not originate as a public policy; rather, it was initially managed by private agents and was founded upon the sense of solidarity. The latter is stronger at local level where face-to-face relationships predominate, but it tends to diminish as the territorial area increases, because solidarity springs from interdependence among utility functions and there is a positive external effect if poverty is reduced. If the redistribution function is assigned to the higher level of government, the amount of the redistribution tends to decrease because, at this level, it is more difficult to foster a real sense of solidarity. It is thus necessary to return, in a certain sense, to the origins of redistribution policy, but without losing the efficacy achieved at national level through creation of the large-scale social security systems that characterize the European model. Interpersonal redistribution should therefore in principle be entrusted to the lowest levels of government, which for that matter are already those most concerned with it.

Instead, significant responsibilities for the territorial redistribution of income should be assigned to the higher level of government, and therefore to the European level. It is necessary to ensure that also poorer areas can enjoy certain minimum standards in the level of public services, so that at least potentially equal opportunities are afforded to all persons resident upon the territory of the European Union. There is consequently an important distinction between the territorial and personal redistribution of income. The European level must undertake territorial redistribution so that equalizing transfers ensure that all areas of the European Union offer equal opportunities (minimum levels of healthcare, education, and so on) and certain basic services are furnished uniformly. The member-states and local communities, for their part, must maintain their responsibilities for the management of social policy and the redistribution of personal income – according to the preferences of each

community – while averting the perverse effects in terms of mobility envisaged by the theoretical model of fiscal federalism. The European Union seems already to be moving towards this structure of redistribution policy by intervening substantially in territorial redistribution through the Regional Fund and the Structural Funds. But it does not concern itself with personal redistribution, which should remain largely the competence of the lower levels of government, even if reform of social security systems should seek to ensure that their structure is such to increase mobility through the standardization of benefits without producing significant net flows among countries (Masson 2000).

8 THE NEW MODEL OF FEDERAL FISCALISM

The role of the European budget is extremely limited as regards the allocative function, given that its size is equal to around 1% of European GDP. The production of public goods and services has historically been undertaken primarily by the state. But today it appears more uniformly distributed among the different levels of government, albeit with marked differences within the Union. In the allocation branch – bearing in mind that a substantial increase in expenditure on a European foreign and security policy is unavoidable in the future, but politically difficult in this phase of the integration process, after the collapse of the European Constitution in the referendum held in France and Netherlands – there are good reasons for the transfer to European level of higher education, since it has significant cross-border externalities, and for the creation of infrastructures with features that make them essential in an European context. Also the common financing of expenditure on research and development is desirable, given that its benefits are not typically manifest at the national level alone. There are probably other sectors in which greater intervention by the European budget is justified; yet it is not in the allocative sector that the future development of the Union's public finance of the union will concentrate.

In conclusion, since the allocative function is largely assigned to the national level of government, the model of fiscal federalism apparent within the European Union is more decentralized than in the theoretical model developed by Musgrave and Oates. Hence, there seems to be little justification for the fears that the creation of the monetary union and the ensuing institutional developments may generate a new, strongly centralized state (Tabellini 2001). The Europe that will come into being will be federal in its nature. The problem is

that today this federal structure – able to ensure both efficiency and the maximum possible decentralization of governmental economic functions – does not yet exist. Hence substantial problems may arise during this transitional phase, and particularly as regards the effectiveness of stabilization policy.

As regards redistribution, a first step towards structural reform has been accomplished with creation of the monetary union, in that the member-states have definitely relinquished monetary sovereignty and, therefore, the possibility of financing redistributive policies with the issuance of money. Today incisive redistribution measures can be financed only to the extent that it is possible to build the consensus necessary for their financing out of taxes – or at any rate by levying the higher taxes which will be necessary in the future to service the new debt produced by welfare policies. On the other hand, welfare services are increasingly allocated to the market or to non-profit organizations, which operate mainly at local level and can be supported by tax benefits decided at national level.

As for stabilization, an increasing proportion of total public spending is now handled by lower levels of government. This therefore raises the problem not only of ensuring efficient economic policy coordination – which is still the only means to manage the Economic Union – at the level of the Union, but also at national level, the purpose being to prevent financially autonomous local governments from increasing expenditure during periods of expansion and reducing it during recessionary phases, with pro-cyclical effects. The task of the state is therefore to manoeuvre transfer policy in such a way as to prevent the onset of these perverse effects.

9 THE FINANCING STRUCTURE OF THE LOWER LEVELS OF GOVERNMENT AND THE INSTITUTIONAL MECHANISM FOR RESOURCES DISTRIBUTION

A further problem is defining the optimal financing structure for the lower levels of government. First to be pointed out is that it now seems widely accepted that local public expenditure should be financed by taxes collected in the territorial area where most of benefits from the spending occur. Also from this point of view, European experience appears highly diversified. But a common problem still persists. The assignment to lower levels of own taxes may ensure autonomy, but it must be supplemented by equalizing transfers for two reasons: on the one hand, the more financial autonomy increases, the greater the need for a system of equalizing transfers; on the other, the

allocation of own taxes to regional and local governments does not guarantee that the dynamics of the revenues will exactly correspond to the dynamics of spending by these levels of government whilst also ensuring the minimum output of the local public goods which the state intends to guarantee throughout the country because it regards them as merit goods.

But the optimal level of transfers cannot be decided independently by the state, for this would seriously curtail the decision-making autonomy of local governments. The aim should therefore be to define a system of public finance governance which ensures participation by lower levels of government in both definition of the equalizing transfers and the assignment of resources to supplement own resources. This institutional mechanism is guaranteed in a federal system like Germany's, in which the Länder participate in decisions by the Bundesrat on the assignment of resources. But in unitary states, once state law has defined the assignment of own resources and transfers, any variation is subject to a further decision by the state, which is generally under the obligation to conduct only non-binding consultations.

The form taken by the institutional mechanisms regulating the distribution of resources is also important for assessment of possible solutions to the problem of the different kinds of competition – vertical and horizontal – that may arise within a system of fiscal federalism. The former, which is normally considered more important, presupposes that the taxpayer is unique and is subject to an overall tax burden consisting of the sum collected by the state and the lower levels of government. Consequently, if the amount of spending is freely decided by each level, which must then collect the necessary resources in accordance with the principles of fiscal federalism, the quantity of resources usable by the other levels is automatically defined once the overall tax burden deemed acceptable in a particular political context has been determined. In this case too, therefore, coordination among the different levels of government appears unavoidable.

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