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# Fiscal Policy and Democracy in Europe

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## 1. Introduction

By adopting the euro as its single currency, the European Union has made significant progress in the efficient management of macroeconomic policy. The single market is less vulnerable to financial, economic and political shocks and even non-euro countries in the Union profit from this fact. However, it has also become apparent that the mix of monetary and fiscal policies has not always been optimal. Domestic demand in Euroland has mostly been feeble, especially when compared to the UK and USA, and fiscal policy has been too lax during the boom year 2000 (European Commission, 2003). This policy weakness has institutional foundations. The integration of national fiscal policies into a coherent European stance is the main problem, as the difficulties of implementing the Stability and Growth Pact reveal. But in addition, the determination of the EU budget in the context of the new financial framework 2007–2013 risks undermining the functionality of the EU. In this paper, I will argue that an optimal policy mix in Euroland requires an integrated fiscal policy framework that also takes into account the budget of the EU.

## 2. The EU's Budgetary Constitution

European Monetary Union has created a unique institutional arrangement for the conduct of European macroeconomic policy: monetary policy is centralised under the authority of the ECB and conducted in a unified and coherent manner. But fiscal policy remains fragmented, with national governments keeping their budgetary authority. They are only loosely constrained by the Excessive Deficit

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Procedure (EDP) and the related application directives, the Stability and Growth Pact (SGP).

This set-up is somewhat surprising, given that the theory of Fiscal Federalism since Musgrave (1959) has emphasised the welfare gains from centralising the public finance functions of stabilisation and redistribution and decentralising the allocation function. Earlier EU-documents, like the MacDougall Report (1979) and the Delors Report (1989)<sup>2</sup> gave a prominent role to fiscal policy: “Both for the purpose of internal macroeconomic objectives and in order to be able to participate in the process of international policy coordination, the Community will require a framework for determining a coherent mix of monetary and fiscal policies” (Delors Report, 1989, p. 94). When the Maastricht Treaty was negotiated, governments were only willing to give up monetary policy, but they kept budgetary sovereignty for themselves. They did this for ideological and political reasons.

Politicians follow the ideas of their time. By the early 1990s, stabilisation policy had been reduced to only maintaining price stability. Employment and output stabilisation were ignored. Fiscal policy at the European level was to prevent the “undue appropriation of EMU savings by one country” (Delors Report, 1989, p. 95) and the crowding out of private savings through excessive deficits. At the theoretical level, the Ricardian Equivalence hypothesis (Barro, 1974) had undermined the Keynesian assumption that government net expenditure could compensate shortfalls in private sector demand. Budget policies were now considered ineffective with respect to “real” economic variables, but they could cause inflation in the long run. Fiscal discipline was seen as necessary to ensure financial stability, but institutions actively pursuing macroeconomic stability were not deemed necessary. Yet, if consumers do not internalise the future tax implication of current deficits (“future generations will pay for them”), Ricardian equivalence fails. After a long debate, it has again been acknowledged in recent years, that fiscal policy can smooth the business cycle by the operation of automatic stabilisers (changes in government revenue and expenditure that arise automatically from fluctuations in economic activity). The new orthodoxy also emphasises the usefulness of discretionary fiscal policies for supply-side effects, such as improving the potential growth rate, covering pension liabilities, creating labour market flexibility, etc. However, discretion for the purpose of demand management is to be avoided (ECB, 2004). Demand is best served by automatic stabilisers, which introduce some flexibility into rule-based policies. These automatic stabilisers therefore contribute to the efficiency of macroeconomic policy, while discretionary supply policies reflect more fundamental choices of collective policy preferences.

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<sup>2</sup> In the paper contained in the Delors Report (1989), Lamfalussy explicitly referred to Musgrave.

The other reason for the EMU's institutional arrangement was political. Initially, more audacious government delegations (especially the French) recognised during the Maastricht negotiation that the loss of national sovereignty on the budget side could lead to a larger EU budget and this would not be politically acceptable (Bini-Smaghi, Padoa-Schioppa, and Papadia, 1994). For example, central government expenditure varies in Australia, USA, Switzerland and Germany between 8% and 14% of GDP, and if social security is included between 18% and 31% , while state and local government only spend between 10% and 14% (Ardy, 2004). Such proportions are considered as unacceptable for the European Union.

Yet, there is a dilemma according to the theory of fiscal federalism. An efficient European budget needs to be small from the point of view of allocative efficiency, but large for stabilisation purposes. The efficient allocation of resources requires that the optimal level of public goods (i.e. that for which the sum of resident's marginal benefits equals marginal cost) reflects the differences in local preferences and costs; because preference heterogeneity is assumed to increase with the number of citizens, decentralisation is supposed to increase welfare and a big EU budget is undesirable.<sup>3</sup> Yet, if government expenditure is to make a difference in terms of smoothing aggregate demand and income, it must be substantial. This condition is generally fulfilled for national budget policies, but not for the EU budget. For example, total government expenditure in the USA was 31.9% in 2003, 33.9% in Japan and 44.5% for the euro area, while the total EU budget represents only 1% of GDP. As Lamfalussy put it in the Delors Report (1989, p. 95): "The size of the Community budget would clearly be too small to provide for an adequate *masse de manoeuvre* for an effective macro-fiscal policy. As a result, in an EMU an appropriate aggregate fiscal policy could not be determined without impinging on the autonomy of national budgetary positions". Given that most of public spending in the EU is undertaken by member state governments (see chart 1)<sup>4</sup>, the stabilisation function in Euroland must work through national budgets. The

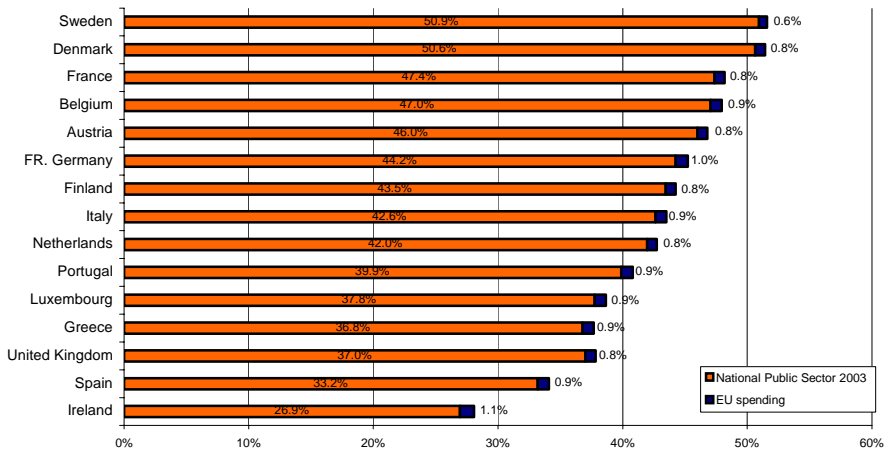
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<sup>3</sup> As Oates (2004, pp. 26–7) points out, "decentralised levels of government focus their efforts on providing public goods whose consumption is limited primarily to their own constituencies. In this way, they can adopt outputs of such services to the particular tastes, costs, and other circumstances that characterise their own jurisdictions." Thus, in this decentralising theory of fiscal federalism, which Europeans call subsidiarity, there is no place for spillover effects of public goods into other constituencies. In Collignon (2003) I have argued that this model is not suitable for policy analysis in the European Union, where spillover effects are widespread. Many collective goods are consumed by all European citizens, although they do not have the institutions to match policy output with the democratic policy input.

<sup>4</sup> All data used in charts and table in this paper are taken from the AMECO data base of the European Commission DG ECFIN unless indicated otherwise.

aggregate fiscal policy stance in Euroland, which matters for monetary policy, is then the book-keeping result of adding up the different national budget positions.

*Chart 1: Total Public Spending as Percent of GDP*



According to the orthodox interpretation, this arrangement does not prevent an efficient policy mix (Artis and Buti, 2000). If member states kept their cyclically adjusted budgets in balance, as postulated by the Stability and Growth Pact, the swing of automatic stabilisers would provide for the efficient counter-cyclical stabilisation of demand shocks. All one needs to do, therefore, is to provide safeguards against opportunistic behaviour by keeping individual member states to some simple rule.

However, this model has come under criticism from two sides. Most has focused on the system's rigidity, which prevents the proper functioning of the automatic stabilisers and inhibits efficient macroeconomic stabilisation. But an additional and much less discussed question is its optimality with respect to satisfying collective preferences.

### 3. The Macroeconomic Stabilisation Function

Fiscal federalism refers to the development of a centralised budgetary system<sup>5</sup> comprising all members of a federation or federal state and how to assign different

<sup>5</sup> This is the half-empty bottle. Of course the same statement can be made in terms of decentralising competencies.

functions of public finance to different jurisdictions (Baimbridge and Whyman, 2004). The classical theory of fiscal federalism has established three major arguments why a monetary union needs to have a centralized budget policy: stabilising symmetric and asymmetric shocks and income redistribution. By contrast, the allocation function may be better served by decentralisation.

### 3.1 Symmetric Shocks

First, there is the argument of *vertical flexibility* in budget policy. Vertical flexibility is about the appropriate response of an economy to a symmetric shock that hits all regions of the federation in a similar fashion. In principle, monetary policy could respond to such a shock by lowering interest rates, thereby stimulating demand. Similarly, a supply shock, such as an oil price increase, would require a unified response in order to avoid beggar-your-neighbourhood behaviour through the distortion of relative prices. It is usually argued that a centralised budget is better able to internalise externalities associated with both taxation and expenditure. Regional governments may not undertake an optimal level of counter-cyclical stabilisation because of the existence of regional spillovers. Non-residents may derive some benefits from an expansionary policy, whilst residents must bear the full cost through higher debt or taxation. This may prevent an efficient policy response. In order to avoid this prisoner's dilemma, coordination of stabilisation policies amongst all members of the monetary union would be required unless a sufficiently large centralised government under federal authority is available. The European approach consisted in coordinating fiscal policies through the Stability and Growth Pact. The Pact stipulates that each member state should keep its budget "in balance or surplus over the medium term". This must mean that governments keep their cyclically adjusted budgets in balance, so that the automatic stabilisers can smoothen the business cycle.

Despite their formal commitments, governments have not exactly followed this model. As chart 2 shows, the structural deficit of the euro area as a whole has improved in the run-up to EMU, but it has remained stable at a level close to 2% since then. It is therefore far from being balanced. The automatic stabilisers did operate in the 2000-boom but the subsequent deterioration of the cyclically adjusted deficit, due to tax cuts in several member states (notably Germany and France), indicates moderate procyclical behaviour in the EU's fiscal behaviour. In 2003, the aggregate Euroland fiscal position came close to the 3 percent line, while several individual member states surpassed it. This is worrisome, for if the euro area were hit by a severe shock (say a further increase in oil prices), the Stability and Growth Pact would restrain the automatic stabilisers and fiscal policy would become pro-cyclically restrictive.

Chart 2: Euro Area Aggregate Fiscal Stance

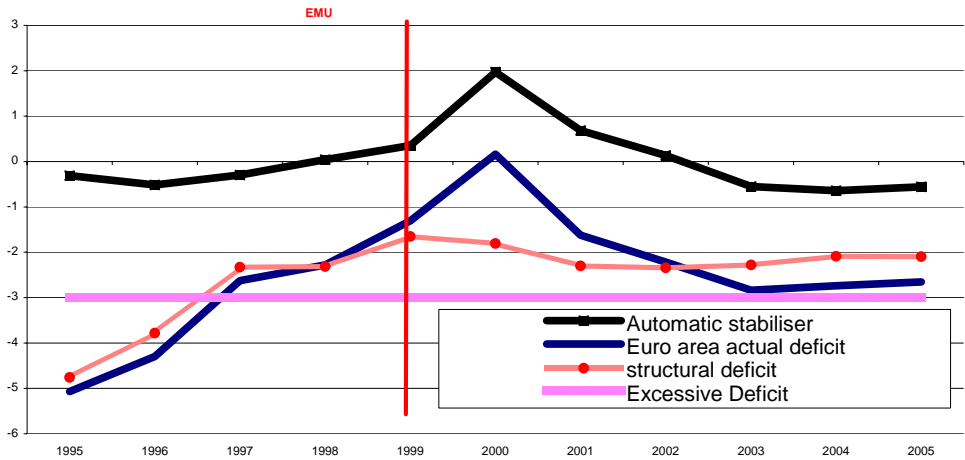
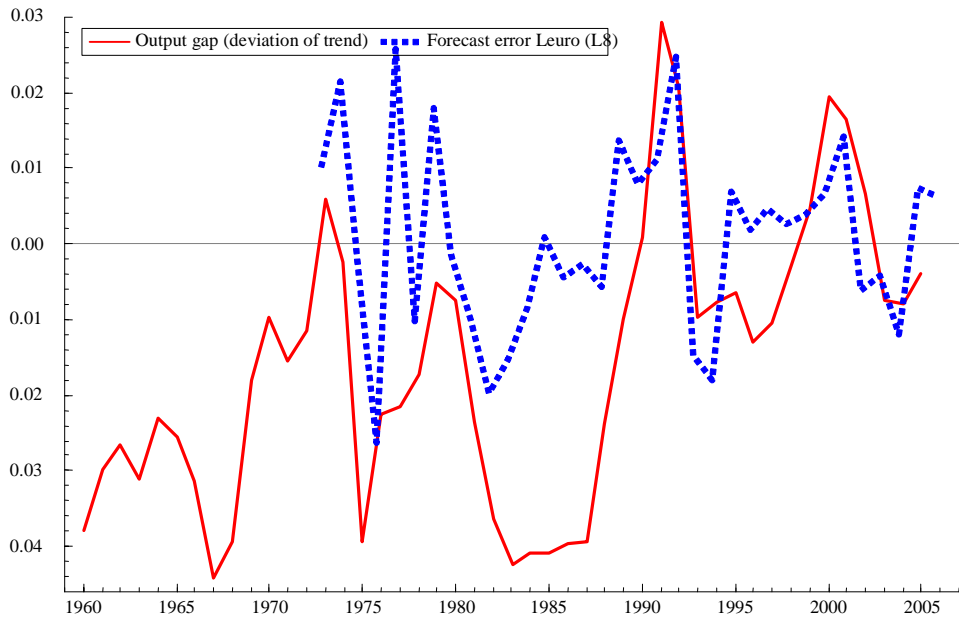


Chart 3: Euro Area Output Gaps and Economic Shocks



Furthermore, economic shocks have recently been less strong than in previous periods. As chart 3 shows, the output gap, as measured by the European Commission<sup>6</sup> has been mainly negative before EMU started. However, given the methodological difficulties in measuring output gaps, I have calculated economic shocks as the forecast error of an AR (8) process for the log of annual Euroland GDP. The volatility of economic shocks has clearly fallen since the mid 1990s. This may be a consequence of monetary integration, or of a favourable environment, but there is no guarantee that it will stay that way. If volatility increases again, more vertical flexibility would be needed in budget policies.

### 3.2 Asymmetric Shocks

Second, *horizontal flexibility* in budgetary policy is required when a federation is hit by asymmetric shocks. In this case monetary policy is not available to stimulate local demand, given its unified tools. Regional budgets could provide additional demand and discriminatory fiscal policies could provide distorting supply side effects. Hence, some form of horizontal policy coordination is desirable.

The salience of horizontal flexibility depends on the likelihood and the extent of regional asymmetric shocks. The discussion of such shocks has been the delight of economists in the context of Optimal Currency Area theory. But since the start of EMU many economists have learned to accept that the occurrence of asymmetric shocks may be related to the degree of economic and monetary integration (Ackrill, 2004; Collignon, 2001). Chart 4 indicates that the movements of national GDP growth rates have become more uniform since monetary union started: the standard deviation of annual national growth rates within the EU and the euro area have been falling. This is all the more interesting, as in previous year a major growth reduction was usually associated with an increase in growth volatility across the area.

How is horizontal flexibility to be achieved? Fatás (1998) has distinguished between *intertemporal* and *interregional* transfers, by which a federal fiscal system can compensate asymmetric macroeconomic shocks. Intertemporal transfers result from government borrowing to stabilise consumers' income in case of an adverse regional shock. Interregional transfers play an insurance role in the case of asymmetric shocks and take place through a federal budget mechanism that transfers income from surplus to deficit areas. While the intertemporal argument follows the traditional Keynesian stabilisation theory, it implies significant externalities and requires policy solutions in a monetary union that are different from unitary nation states. For if the central bank keeps money tight to ensure the economy's hard budget constraint, the extra borrowing of one region would push

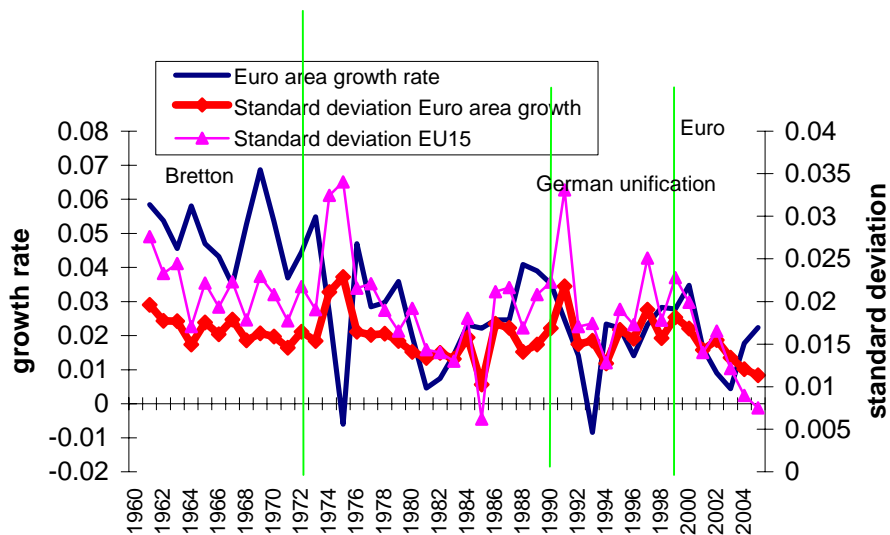
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<sup>6</sup> Calculated as the deviation from trend output based on a production function.



interest rates up for the whole economy.<sup>7</sup> One reason for the SGP was the intention to prevent individual member states from free-riding on intertemporal transfers, at the expense and detriment of others. However, this disciplining device comes at the cost of less than optimal stabilisation in a country hit by an asymmetric shock. For if there is no interregional transfer mechanism, all the adjustment would have to be made by intertemporal transfers region by region, and if the amount of borrowing exceeds the permissible norm of the SGP, stabilisation is impeded. This negative result could not be avoided if asymmetric shocks were normally distributed because there would be no need to constrain deficits. Additional borrowing by one region would be funded by unexpected government savings in another region. On average, the capital market would remain in balance and interest rates would not be affected. The overall hard monetary budget constraint would be binding and price stability would be maintained (*ceteris paribus*). However, given the very unequal distribution in member state size, it is unlikely that asymmetric shocks in Euroland have a zero mean. Therefore, intertemporal transfers interact with aggregate macroeconomic stability and they cannot substitute for interregional transfers.

*Chart 4: Asymmetry of Shocks in the Euro Area*



<sup>7</sup> This is an argument about the short-term interest rate in the money market, which is controlled by monetary authorities. If the long-term interest rate in the capital market were fixed by the international supply and demand for capital, the yield curve would be negatively affected by regional borrowing.

Federal systems often seek to overcome these difficulties by establishing a system of interregional transfers, which provide insurance against asymmetric shocks by pooling the risks of national income fluctuations at a higher level of aggregation (Schelkle, 2002). An interregional public insurance scheme redistributes income from favourably shocked to adversely shocked regions, while maintaining the overall stability of the aggregate fiscal policy stance required for maintaining price stability.<sup>8</sup> In mature federal states, like the United States of America in the 20<sup>th</sup> century, these horizontal transfers are affected through the federal budget. In Germany, the *Länderfinanzausgleich* (interregional transfers) also requires the federal budget to balance inconsistent regional claims. In the European Union this is more complicated. Regional stabilisation does not work through an insurance scheme, but essentially through intertemporal transfers when national budget deficits respond to asymmetric shocks through the mechanism of automatic stabilizers. But as argued above, this is not optimal. The European budget is small (less than 1.2% of GDP) and its two main spending categories, agriculture and regional policy, reflect redistribution objectives, not stabilisation. Interregional transfers do not reflect economic shocks but more fundamental preferences for income redistribution.

### 3.3 The Redistribution Function

The redistribution function of the EU budget relates to our third argument in favour of centralising budget policy in federations. After passing the Single European Act, it soon became clear that continued political support for the Union required solidaristic transfer schemes to help economically weaker regions. In principle, these transfers could either be financed through intergovernmental grants, or through progressive taxation as in many nation-states. In the EU, intergovernmental grants are not financed by a transfer from a federal budget to lower level jurisdictions, but by transfers from national budgets to the EU budget. In fact, 80% of the European budget spending consists of transfers, half of them through the common agricultural policy, the other half for regional policy. This spending is financed by the so-called *own resources* of the European Union that have, however, little to do with own resources (the only exception is a small amount of income from customs duties). The funding of the European budget is actually a levy on national government's budgets that automatically balances the EU budget by claiming transfers in proportion to GDP (Brehon, 2004).

This system has far reaching consequences for the legitimacy, acceptance and sustainability of European budget decisions. When transfers are channelled through a federal budget, the budget decisions reflect aggregate citizen's preferences as

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<sup>8</sup> The welfare gain from such insurance device declines, of course, as the likelihood of idiosyncratic shocks diminishes. See chart 4 and Ackrill (2004).

they have emerged from the electoral process at the federal level. These choices may conflict with partial interests of regionally regrouped voters, but there is a legitimate debate between the two levels that, in principle, articulates the interests of all citizens concerned. This is not so in the European case. The aggregate interests of European citizens cannot be articulated, because budget decisions are the exclusive domain of national governments.<sup>9</sup> Only the partial interest of national representation in the Council is possible. As a consequence, decision options that would maximise the aggregate utility of all European citizens carry less weight than the bargained Nash equilibria which are the result of intergovernmental bargaining in the Council. This is of particular relevance for distributional issues.

The budget of the European Union is a redistribution budget. 80% of expenditure is concentrated on the common agriculture policy and structural or cohesion funds. The former aims at stabilising income of a specific group of the population; the latter provides matching grants to accelerate regional development. Given, that the European Union budget is not allowed to borrow in capital markets, all resources are effectively transfers from national treasuries. National governments contribute to the European Union budget roughly by size of their country's GDP and they receive funds back from the European Union in accordance with the criteria and tasks established for disbursement. Thus, countries with high concentration of agriculture or of poor regions receive more funds in return, than countries who have more balanced structures or are wealthier. In recent years, 4 countries, out of 15 EU countries, have been net-transfer recipients, 10 were net contributors, and in Finland inflows and out flows were balanced. European net-contributions must therefore be seen as one expenditure item amongst many others in national European budgets. Yet, given that the overall fiscal policy framework requires national government budgets to be balanced over the business cycle and that governments have to avoid excessive deficits, the amount of net contributions distorts fiscal discipline and undermines European stability. For if a national government needs to consolidate its budget, a net transfer of funds to European citizens who are not voters in the government's constituency is not easily justifiable. This explains partly why discussions of the net contribution to the European budget are so highly charged by EU Member States.

The EU budget system, linked to the fiscal discipline devices of the SGP, creates an awkward dilemma: the more generous a member state behaves in transferring resources to poorer countries, the higher the likelihood that it will be punished under the Excessive Deficit Procedure, if it is hit by a shock. Each Member State therefore has an incentive to reduce its contribution to the EU

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<sup>9</sup> The Convention preparing the draft European constitution gave increased budgetary power to the European Parliament, but in the subsequent Intergovernmental Conference national governments withdrew these arrangements and preserved their exclusive authority.

budget in order to comply with the SGP. This arrangement increases the risk of European disintegration, particularly at a moment when the accession of ten new low income countries creates additional claims for resource transfers.

Table 1 gives an idea of the magnitudes in 2002. Net budget transfers into Greece and Portugal exceeded 2% of GDP; in Spain and Ireland they were close to 1¼ percent. However, the effective tax burden on citizens in the Netherlands are nearly ½ percent of GDP and a quarter in Sweden, Germany and Italy. Only Finland is in balance. In 6 out of 14 countries (data for Luxemburg were not available) the net contribution to the EU budget is higher than the magnitude of the automatic stabilisers in 2002. As a consequence of the net transfers, Portugal remained below the 3% deficit level of the EDP, and France was pushed beyond the limit. If the Netherlands would wish to balance their structural deficit, as required under the SGP, their consolidation efforts have to be 24% higher than if their net contribution were balanced. For Italy the extra effort is nearly 10%, for Germany 7% and for France 4%.

*Table 1: European Net Contributions and Budget Deficits 2002*

In % of GDP	Net contribution	Cycle deficit	Structural deficit	SD-NC	Actual deficit	AD-NC
	NC		SD		AD	
Portugal	2.08	0.02	<b>-2.72</b>	<b>-4.81</b>	-2.71	<b>-4.79</b>
FR. Germany	-0.24	-0.15	<b>-3.37</b>	<b>-3.13</b>	<b>-3.52</b>	<b>-3.28</b>
France	-0.14	0.56	<b>-3.66</b>	<b>-3.52</b>	<b>-3.10</b>	-2.96
Greece	2.40	1.31	<b>-1.46</b>	<b>-3.86</b>	-0.16	-2.55
Italy	-0.23	-0.01	<b>-2.30</b>	<b>-2.07</b>	-2.31	-2.08
Austria	-0.10	-1.43	-0.15	-0.04	-1.58	-1.47
Belgium	-0.10	-1.54	0.02	0.12	-1.52	-1.43
Spain	1.27	-0.12	0.21	-1.07	0.09	-1.18
United Kingdom	-0.17	1.18	<b>-1.41</b>	<b>-1.24</b>	-0.24	-0.06
Ireland	1.22	3.16	<b>-1.87</b>	<b>-3.09</b>	1.29	0.07
Netherlands	-0.49	2.11	<b>-2.05</b>	<b>-1.56</b>	0.05	0.54
Sweden	-0.29	1.06	0.81	1.10	1.87	2.16
Denmark	-0.09	1.33	1.11	1.20	2.44	2.53
Finland	0.00	0.44	3.75	3.76	4.20	4.20

*Source: European Commission.*

Because the four cohesion countries receive a net contribution from the rest of the Union, their excess of expenditure over national tax income can go above 4% of GDP. On the other hand, net-contributors to the European budget are severely restrained in their borrowing capacity. In particular Germany, which has arguably the need for a significant amount of borrowing in order to finance the restructuring of public infrastructure in Eastern Germany, the limit on the borrowing capacity for

national purposes is not 3%, but 2.74%. Thus, we may conclude that the burden of fiscal discipline on national budget policies is not equitably distributed and does not provide a regional insurance scheme for asymmetric shocks. These two failings are a double threat for the legitimacy and sustainability of European integration. How could they be remedied?

## 4. Integrating European and National Budget Policies

An efficient European budget arrangement should provide vertical flexibility in order to deal with macroeconomic shocks affecting the whole euro area, and horizontal flexibility that allows the stabilisation of asymmetric shocks in specific countries. In addition, it should have a mechanism whereby the European budget reflects the preferences of European citizens for the public goods they share, including their views on stabilisation, redistribution and solidarity. I will now suggest an institutional arrangement, capable of integrating those three requirements. It will also increase the efficiency of fiscal policy by strengthening its democratic legitimacy.

### 4.1 Defining the Aggregate Fiscal Policy Stance: Vertical Flexibility

What matters for macroeconomic stabilisation in a single currency area is the mix, or rather the interaction, between monetary and fiscal policy. But because monetary policy is fully unified, fiscal policy also requires a coherent, unified aggregate stance. Given, that the bulk of expenditure in the EU is allocated by national governments, a mechanism is needed to define the desired aggregate fiscal position (total public expenditure minus revenue). This aggregate fiscal policy stance should reflect the economic conditions of the whole of European Monetary Union, but also collective preferences for the allocation of resources, including their distribution between national and European public goods. However, once the aggregate deficit is defined at the European level – which is where it belongs to fulfil the stabilisation function and implementation could take place at the level of the appropriate jurisdictions – each jurisdiction must be assigned a share of this total deficit for implementation. Within their quota national governments would then set the priorities for collective goods that reflect their voters' preferences. For example, one country may have a preference for a large public sector and therefore higher taxes, while another may opt for small government and low taxes, but both must stick to the authorised net borrowing requirements. This idea addresses the earlier mentioned dilemma, whereby the stabilisation function of public finances needs to be efficiently dealt with at the central level, while the allocation function can respond flexibly to preference heterogeneity.

Technically the procedure of first defining the macroeconomic aggregate and then its micro application in a second step is not unusual. For example, the French parliament votes first a macroeconomic framework law, so that the subsequent detailed item voting within the overall budget constraint (*les arbitrages*) ensures that specific preferences remain coherent with the overall stability requirement.<sup>10</sup> Similarly, the budget process in Italy defines first the multi-annual macroeconomic framework law, the Programmazione Economico e Finanziario (*DPEF*), and then the *legge finanziaria*, which implements the actual budget allocations (Amato, 2000). In the European context, there exists an instrument that could be developed to serve an efficient budget process. One could redefine the Broad Economic Policy Guidelines (BEPG) to take the function of a binding annual macroeconomic framework law. These guidelines would set the authorised *aggregate* spending and income targets for all EU public authorities (from municipalities to regions, nations and the EU budget), as they seem relevant from a business cycle point of view, but also with respect to intergenerational burden sharing. As such the BEPG would effectively define the aggregate budget deficit of the European Union for any given year. This would ensure vertical flexibility of Europe's fiscal policy. The transformation of the BEPG into a macroeconomic framework law does not prevent them from continuing their function of giving orientation and direction to Member States for the European economy's supply-side reforms.

However in order to make these revamped BEPGs a binding legal commitment that entitles the European Union to superimpose budget rules on national parliaments, it is essential that they have full democratic legitimacy. It is obvious that an un-elected Fiscal Policy Committee of "experts", as suggested by Wyplosz (2002), is totally incompatible with fundamental democratic norms.<sup>11</sup> But political legitimacy cannot simply be derived from the legitimacy of national governments represented in the Council. In a representative democracy citizens are the principals who charge governments as their agent with the task of implementing their collective preferences, or at least those of the majority. If the agent does not perform, or if the preferences change, the principal must have the right to remove

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<sup>10</sup> In fact this arrangement was one of the essential innovations of the Fifth Republic on the fiscal policy side.

<sup>11</sup> Wyplosz (2002) argues "budget deficits have a limited intra-temporal reallocation effect. They mostly redistribute income across generations, most of which are not yet in existence and play not part in democratic control. Democratic control is essential for deciding the size of government, the distribution of spending and the structure of taxation, but it has proven inefficient to set the size of the budget deficit." Such an approach does not understand that democracy is about more than the technocratic efficiency or policy output. It is also about policy input legitimacy. The deliberative aspect of democratic collective choice is what distinguishes a dictatorship, even an enlightened and benevolent one, from a regime where citizens are free and equal. See Elster (1998).

and appoint another government. Otherwise the agent loses legitimacy. It is an important feature of democracies, partly caused by the information asymmetry between principal and agent,<sup>12</sup> that this verification takes place at periodic intervals through elections, in which each citizen has an equal share in the decision-making. The periodicity is necessary for the protection of human rights and to ensure the efficiency of government action, which must not be disrupted by frequent stochastic shocks in public opinion (Elster, 1993). But also, most importantly, electoral campaigns play an important role in the formation of collective preferences by correcting the asymmetric information problem between principal and agent.

The exchange of ideas, views and opinions between citizens who listen to each other and express their individual policy preferences prior to elections accelerates the emergence of a policy consensus around the median voter (Collignon, 2003). Without the focal point of periodically reoccurring elections, preference heterogeneity is likely to persist. This is the reason for the persistence of heterogeneity in European preferences. Thus, contrary to the theory of fiscal federalism, we must not assume collective preferences as exogenously given, but consider their change and evolution as a result of the institutional processes of collective deliberation. This also explains why the democratic deficit in Europe cannot be closed by the European Council. For although one may argue that national citizens are represented by their governments in the Council, there is no mechanism by which the European principal can revoke the agent (i.e. the European decision-maker namely the Council), if it does not perform, because there is no election for a European government. Governance without government, which is the intergovernmental method, implies there is no agent that can be made accountable and revocable. The European Commission is the agent of governments, the derived agent of the agents.<sup>13</sup> Consequently there is also no European-wide deliberative process that would help to overcome preference heterogeneity. The Council is in fact an eternal parliament that is continuously renewed by by-elections. Such a system can hardly be called a democracy and it should surprise nobody that a European Union run by intergovernmentalism will ultimately lose the trust of its citizens and cease to be effective. The conclusion is simple: for the whole range of public goods, which affect each European citizen,

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<sup>12</sup> The asymmetric information problem in principal-agent relationships arises from the fact that the agent can use information from running the business for his own use, while the principal may not have access to such information. Quite obviously this is the case in all representative democracies.

<sup>13</sup> The rejection of the Barroso Commission by the European Parliament shows the dilemma: the president and the commissioners are nominated by the Council and do not necessarily reflect the views and majorities that emerged from the Parliament' elections. However, the fact that the EP has to consent is an important step towards a European democracy.

there has to be a democratic process to establish their collective preferences. Each citizen must have the right to cast a vote, and to participate in the deliberations about collective European choices. They must be able to express, discuss and control their collective choices; the appropriate instrument for this is the European Parliament.

It follows that, if the EU would aim to establish the aggregate European budget position as a framework law, the authority for such budget procedure must be with a European institution which is accountable to all citizens, because the consequences of fiscal policy affect every citizen in Euroland. The fiscal policy stance should, therefore, be proposed by the European Commission and then voted by the European Parliament. Subsequently, it would obtain the Council's agreement according to the appropriate legislative procedure. The Council has, of course, a legitimate interest in weighing in on the collective decisions, as European choices may have externalities for local choices. The advantage of this arrangement is not merely procedural. It creates a public domain for the discussion of collective preferences with respect to the fiscal policy choices and the consequences of public borrowing for the level of interest rates. It would therefore contribute to a better understanding of the policy choices and by strengthening their legitimacy, it would also improve the efficient conduct of European fiscal policy. But even more importantly, by creating a public domain for fiscal policy choices our proposed arrangement would open the door to a proper European democracy. As many authors have pointed out, (Eriksen and Fossum, 2000; Beetham and Lord, 1998; Habermas, 1996), democracy does not require a "demos" with ethnic loyalties and references to a common past, but an agreed political project for a common future. By creating the structures for European policy deliberation involving all citizens concerned, a European identity and with it the European demos will emerge as an unintended consequence.

## 4.2 Assigning National Deficits: Horizontal Flexibility

Once the aggregate fiscal policy stance has been determined, the respective shares of income, expenditure and deficits have to be allocated to national governments. An obvious benchmark for the allocation of these shares would be the GDP-weight of respective member states. However, this does not take into account asymmetric shocks or heterogeneous preferences for the intergenerational distribution of tax burden. A mechanism is therefore necessary that introduces horizontal flexibility to deal with deviation from the initial allocations without violating the aggregate policy stance.

One method would simply be to leave the authorisation for deviations to negotiations in the Council. No doubt, this solution would delight civil servants in national administrations. But the procedure would be highly intransparent and reinforce citizens' perceptions of an undemocratic European Union. A more elegant



way could be the introduction of tradable deficit permits (Casella, 1999). Under this procedure each member state would obtain tradable deficit permits reflecting the GDP-weighted proportion of the aggregate deficit defined by the macroeconomic framework law (BEPG).<sup>14</sup> If a country chooses to borrow more, it would have to buy additional deficit permits from countries, which do not wish to use their own quota. Deficit permits therefore ensure interregional transfers, without intertemporal distortions. Hence, the overall budget constraint, which matters for the conduct of monetary policy, is respected.

One advantage of tradable deficit permits is their decentralised applicability. A deficit permit gives the right to borrow and the banking system could be legally prohibited to lend to public authorities that do not have the required deficit permits. Sanctions are therefore self-policing and self-enforcing and no elaborate political process à la Stability Pact is required. Implementation can also be decentralised to lower level jurisdictions (regions, municipalities, etc.) as long as they have borrowing authority. National governments would then have to set a domestic procedure for re-allocating their national quota to lower level authorities. This solves one of the vexed problems of *domestic stability pacts*, which has been a major obstacle for meeting the Maastricht criteria in federalist states, such as in Germany.

Furthermore, by making these permits tradable, the political option of borrowing versus taxing obtains a price that reflects the relevant scarcity of funds. The procedure therefore invites a public debate about citizens' preferences. It thereby contributes to the democratic decision-making in budget policies in the European context and mitigates the tension between aggregate European and partial national interests. Thus, democracy becomes an instrument of European integration.

#### 4.3 Harmonising European Preferences: European Public Goods

The issue of democracy also becomes relevant for the efficient provision of European public goods. As I pointed out above, the arrangement, whereby the EU-budget is a derivative of national budgets, risks disintegrating the Union when under the pressure of partial national interests financial resources are no longer allocated to the required common European tasks. Choosing the quantity and quality of common European goods must be the ultimate responsibility for tax payers, i.e. voting citizens. But what are European public goods?

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<sup>14</sup> More sophisticated solutions could be incorporated. For example, Coeure and Pisani-Ferry (2003) have suggested that, in the interest of the intergenerational smoothing of the tax burden when financing public investment, governments could be allowed to borrow more than 3% of GDP, provided their debt ratio is well below 60%.

The theory of fiscal federalism has emphasised that the allocation function of public finances should be decentralised as far as possible, when collective preferences between communities are heterogeneous. However, apart from the fact that this theory assumes preferences as exogenously given, it largely ignores externalities and spillovers from one jurisdiction to another. For, if policy decisions reflecting the collective preferences in one jurisdiction affect the utility function of citizens in another jurisdiction, then decentralisation will not necessarily be welfare maximising. We may define a European public good as the provision of services, which have the capacity to enter the utility function of each European citizen. Similarly, a national or local public good is defined by affecting only a well-circumscribed group of localised citizens. Hence, decisions about the provision of European public goods concern each and every citizen and should therefore be subject to democratic control at the EU-level.

On the other side, the utility of national public goods are not only the outcome of national democratic processes, but they may also be affected by decisions in other jurisdictions. In the later case, cooperation between local/national governments may be sufficient for the internalisation of externalities. But for European public goods this is not enough. Their provision requires democratic legitimacy and control for the same reasons, which were mentioned above in relation to the vertical flexibility of stabilisation policy. In fact, macroeconomic stability is an example for a European public good under our definition. But if the decision about the provision of European public goods is taken at the EU-level by democratic institutions like the European Commission together with the European Parliament, then the funding of these goods also needs to be decided at that level. Hence, the revenue for the EU-budget should be raised by a proper European tax and no longer by a transfer from national budgets.

In order to disentangle national and European budget decisions it is necessary to give full budgetary sovereignty to the European Union institutions for their own budget. This implies that the European Parliament has authority over expenditure of the EU budget and taxing European citizens accordingly.<sup>15</sup> This does not prevent the Council from still having some co-decisional responsibilities, because obviously the provision of EU collective goods and the related taxation would have spillover effects on national utility functions. One could, for example, envisage to set jointly agreed limits to the EU budget's size, such as keeping the European budget below one, 2% or 3% of GDP – as done today under the Financial Perspectives system. But the crucial point is that the ultimate responsibility for the

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<sup>15</sup> The Convention preparing the draft European constitution gave increased budgetary power to the European Parliament, but in the subsequent Intergovernmental Conference, national governments withdrew these arrangements and preserved their exclusive authority. This is another example for the undemocratic character of intergovernmental policy making in Europe.

EU budget is no longer with governments acting as agents for partial interests, but with citizens – hence the principal.

Raising a Euro-tax would disarm the disintegrating tendencies resulting from the above-mentioned fact that the EU budget is an item in the spending plans of national treasuries. It would remove the unequal fiscal constraint imposed by the SGP on net contributors to the EU-budget. Every national government would have exactly the same borrowing capacity of say 3% of GDP – or whatever else is agreed under the macroeconomic policy framework. Additional projects in net recipient countries would be funded by the Euro-tax affecting every citizen in an equitable manner and eliminating today's nationalist biases in the funding for European public goods. This does not imply a higher tax burden for citizens, as the national government's revenue should be reduced pro rata. Instead every citizen would have to evaluate prior to EP-elections whether his/her tax money is spend for the European public goods he or she desires and which political parties reflect their preferences best. The existence of a democratic process to determine this at periodic intervals is also necessary for the gradual convergence in policy preferences in Europe. It has the advantage that the disintegrative budget haggling between national governments that occurs every seven years when deciding the Financial Perspectives would cease, and a clear assignment of responsibilities for public expenditure would be assigned to the different levels of the European Union.

Several technical questions need to be clarified. First, what should be the appropriate tax base for such a euro tax? The obvious candidates are transactions in the European Single market. It could be limited to goods and services or to factors of production. In the first case, the euro tax could become a small basic portion of VAT, that is substituted for the national revenue. In the second case, it should be based on mobile factors of production, essentially corporate or capital income. This latter approach has the advantage of removing tax distortions in the single market that are caused by the desire of national governments to retain domestic investment and to attract FDI.

Second, once the tax base is decided, the tax rate depends on the amount of revenue, which needs to be raised. Today's EU budget amounts to approximately EUR 100 billion or approximately 1% of GDP. In 2004, total indirect taxes amounted to EUR 1,310 billion, and in 2002 total corporate gross income was EUR 1,377 billion<sup>16</sup>. Thus, a refinancing of the existing budget would amount to a small portion of VAT, certainly not more than 2 percentage points, and a reasonable corporate tax rate.

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<sup>16</sup> Data from European Commission, AMECO data base.

## 5. Conclusion

With the creation of EMU, the role of national financial policy has changed and a more coherent approach to macro-economic policy is required to improve efficiency. But at today's level of integration, policy efficiency requires democratic legitimacy, the interaction between the Stability and Growth Pact and the European budget have the potential to disrupt the Union's capacity to provide itself with the public goods it requires. In the context of the SGP, additional claims on the EU's public finances, resulting from enlargement, will increase the dangers of political conflict and disintegration

What is required is a coherent fiscal policy that has democratic legitimacy and delivers the economic growth necessary to accommodate the expectations of Europe's citizens. Inventing new ways for Europe's fiscal policy may be a rewarding enterprise.

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