The European Union: How to Assign the Functions of Government?

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1. Introduction

Once again Europe is at a turning point. After several years in which the construction of Europe had rapidly gathered momentum, 1992 and 1993 brought moments of severe difficulty. Just as everything seemed ready for the definitive establishment of the European Central Bank that was shortly to usher in the Union's single currency, the Exchange Rate Mechanism suffered a serious setback. But Europe's future was traced out at Maastricht and we must proceed along that path.

The central elements in the strategy of European construction are the widening of the internal market, making it a level playing field, and the erection of institutions with government functions at the supranational level. Since the mid-1980s attention has focused on monetary matters and on the need for a central institution which, by controlling the money supply and guaranteeing price stability, would free the single market of the risk of inflation and of exchange risk between member countries. The importance of a single European monetary authority – for its economic benefits, for the very stability of the federal structure and for the easing of social strains within the federation – was lucidly underscored as far back as 1944 by Luigi Einaudi. Analyzing the economic tasks of the projected European Federation, Einaudi wrote:

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> There appears to be no reason to question the evolution to the federation of the task of regulating money and money surrogates. The present disorderly state of currency units all around the world, the difficulties in trade stemming from exchange rate uncertainty and, worse still, the impossibility of currency exchange have made the advantages of adopting a single currency throughout the territory of the federation plain for all to see. What a simplification it would be if all of Europe, or at least the entire European Federation, were to perform calculations, keep accounts and set the prices of goods and services in, to use a neutral term, "golden lire"; what ease of payments, money transfers and settlement! [...] The benefit would not consist solely in the simplicity of accounting and the convenience of international payments and transactions. Great though it would be, that benefit would be minuscule by comparison with another, much more precious advantage, namely the abolition of the sovereign power of individual states in monetary matters. [...] If the European Federation takes away the federated states' authority to finance public works by operating the banknote printing press and obliges them to finance their activities solely through taxes and voluntary loans, it will by that alone have accomplished a great deal, infusing a dose of healthy, effective democracy; for the rulers of the federal states could no longer hoodwink the people with the mirage of cost-free public works through the miracle of paper money but would have to win consensus for new taxes or credit for new loans by demonstrating their capacity to provide effective services to the citizenry. (Luigi Einaudi, *La guerra e l'Unità Europea*, 1948.)

Having thus assigned monetary powers, Einaudi went on to discuss which taxes ought to be assigned to the federation and above all which functions, specifically in the sphere of trade and transportation. This same logical course has been followed by more recent authors.[1]

Similarly, Economic and Monetary Union (EMU) carries the potential for further developments, most especially in the sphere of public finance. In our view, it also needs reinforcement in this field, which poses more than one question. For instance, does the absolute centralization of monetary policy necessarily entail the federalization of fiscal policy? If so, to what extent and for what responsibilities? In short, the principles of multilevel public finance for Europe need to be defined.

The purpose of this article is to review the economic theory of multilevel government finance and inquire into the optimal assignment of fiscal responsibilities to various government tiers both in an abstract

[1] For instance, Oates (1972).

federal framework and in the concrete case of the European Union. In Section 2, a brief account of the road the European Community (now the European Union) has traveled and the factors making for crisis and for success in the integration process is followed by a reexamination of the theory of division of fiscal functions among levels of government, an analysis of the assignment of tax powers and a discussion of the most important conclusions of this theory. Section 3 outlines a possible model of multilevel public finance for the European Union. Europe's peculiar characteristics (scant labour mobility, incomplete integration of markets, the lack – hopefully, not for much longer – of a common monetary policy and of a sizable federal budget) counsel adapting the canons of multilevel finance as applied in existing federal systems to Europe's specific conditions. In particular, we inquire which level of government should be assigned the redistributive, stabilizing and allocative functions. We also discuss two possible strategies for the future integration of Europe: one centring on the mechanism of competition, the other on coordination and cooperation between government institutions and levels. Section 4 treats several questions central to the possible administrative and fiscal decentralization in Italy.

2. The theory of multilevel public finance and federalism

2.1. *Factors of success and of crisis in European integration*

Europe now finds itself at a delicate passage. After a period of great activity during the 1960s, a decade of schlerosis in the '70s and another period of major initiatives (1982-1992), the Union is once again at a crucial turning point. The timetable is no longer certain, and in some cases not even the route. Operationally, there are doubts whether the project set out in the Maastricht Treaty is really practicable.

Just as everything seemed ready for the definitive completion of the single market and the realization of the first embryos of a federal union, the collapse of the Berlin Wall, the end of the Cold War, the implosion of the Soviet Union, the German unification and the Yugoslav crisis transformed the entire strategic context, cooling the impetus towards

Community and dredging up ancient nationalistic drives and seemingly forgotten religious intolerances. Perhaps the greatest stumbling-block on the path to Community integration was German unification, which upset the delicate political and economic equilibria that had been so laboriously achieved at the end of the '80s. It raised new defence requirements for Europe,[2] exacerbated the inconsistencies between monetary policies and triggered renewed instability in the foreign exchange markets. At the same time it made the costs of enlarging the German federation to the eastern *Länder* evident and fully perceived, giving Community citizens grounds for alarm at the prospective costs of European unification. Germany's decision to finance unification by borrowing[3] had the effect, in recession, of aggravating the conflict between external constraints and internal conditions within the member-country economies, setting the stage for the crisis of the EMS in 1992 and 1993. The Maastricht strategy of gradual preparation for Phase III of EMU through increasing convergence among the member economies was thus threatened. Even though the creation of the European Monetary Institute adhered perfectly to the timetable for the creation of the European Central Bank, in the present state of affairs it is hard to say when, or even how, the process of monetary union can resume its advance.

The current difficulties of the European Union reflect an unsatisfactory strategic approach to the federal construction of Europe and the reluctance of the member countries to sponsor the clear and direct creation of federal institutions. So far the architects of European Union have had to work with a restricted notion of sovereignty. The postwar Community has not developed the functions that have historically characterized the sovereign state. The member nations have focused their efforts on other, immediate objectives, such as social welfare and the strengthening of economic performance. The European democracies have devised methods of achieving these objectives and consolidating consensus, encouraged in this by the unbroken era of peace enjoyed by Europe since 1945 thanks to American protection.

The strategy of economic and commercial integration was an undoubted success, producing major benefits for the area. Today the Community edifice unquestionably possesses some elements of statehood in its institutions (Parliament or lower house, Council or upper house, Commission or government, Court of Justice), in its procedures (direct popular election of the Parliament) and in its status (accreditation of ambassadors). Yet EC countries embarked on progressive integration without considering (and in effect putting the question off) whether Community institutions were suited to take on the central functions of the sovereign nation-state (defence, currency, taxation).

This was largely because during its first three decades the Community lacked the unanimous conviction on the part of national governments that the strategy of integration would eventually have to be transposed into the construction of federal bodies. Indeed, if we except rare, more enlightened pro-European positions, the prevailing attitude was that the EEC was just a tool for achieving major economic benefits through the common market. This may explain why to this day the Community institutions still lack the substantial independent powers that the member states possess.

However, once economic integration was well advanced and time came to proceed towards a union transcending the strictly economic sphere, this contradiction became manifest. The strategy of gradual federalist transformation of the Community exploiting the momentum of economic integration[4] is subject to the limitation that beyond a certain point the retention of member-state power in the key policy areas comes into conflict with the construction of the corresponding Community policy.[5]

The institutions of the Community still lack independent sources of authority to which to appeal when hard choices have to be made. As the mere sum of twelve national governments, the European Council has not been and can never be an appropriate institutional point of departure for the definitive achievement of integration. The decisive question is whether the member countries are now willing to form the embryos of federal organs within the European Union and relinquish significant portions of their policy independence at the national level.

The end of the Cold War removed the immediate reason for the Community's being (a shield along the eastern frontier) and revived the

[2] Notably for France, which moved immediately to contain German geographical and military expansion by the formation of a joint Franco-German army corps.

[3] Hence, with higher interest rates, as recurrent raises have been enacted partly to block any resurgence of inflation due to the costs of unification.

[4] This is unquestionably the intention that informs the Commission in its action, although very broad differences of opinion among the national governments over the future of the European Union remain.

[5] In the case of taxation, for example, fully independent national tax systems are incompatible with full freedom of movement of goods and capital.

spirit of nationalism not just in Eastern Europe but within the Union itself. The risk is that the enlargement of the Community to virtually all the EFTA countries and, in the future, to the East may weaken the prospect of a federal Union still further.

In our opinion, European integration will inevitably resume its forward progress, but at present neither the manner nor the forcefulness of this recovery is clearly discernible. Today the Union is still torn between a supranational and a proto-federal structure, but with entry into Phase III of EMU, *i.e.* with irrevocably fixed intra-Union exchange rates or a single currency, it will swing decisively towards the latter. It is from this perspective that we shall discuss public finance in a multilevel structure covering the full spectrum from the Union to the single municipality.

2.2. *The theory of multilevel public finance*

In a rational, ahistorical process of unification, the fundamental question Europe should pose is what structure of government promises the greatest success in solving the problems of allocation, distribution and stabilization within the Union. Except for the last few years, the debate on federal construction and the division of functions among the various levels of government has largely ignored[6] the economic theory of fiscal federalism[7] and failed to give systematic consideration to the experience of existing federal countries. Reinterpreted and adapted, the theory of fiscal federalism could at least provide a frame of reference for the construction of Europe and the division of responsibilities among the various levels of government.

First of all let us recall the meaning, in economic theory, of multilevel public finance. The classical point of departure is the distinction among the main functions of the public sector offered by Musgrave (1959, p. 5).[8] The fundamental task of the theory of multilevel public finance is to guide decisions concerning allocation, distribution and stabilization and determine the optimal level of government to which to assign these functions.[9]

The allocative function of government should ensure the efficient use of resources, *i.e.* making necessary adjustments to the spontaneous allocation effected by the market, determining the tax and expenditure policies necessary to the purpose and sharing the costs among citizens. The economic stabilization function is directed to the objective of a high level of employment with price stability. The redistributive function is directed to establishing a fair distribution of income.

For operative purposes, then, the crucial question for a system with more than one government jurisdiction is which one should be assigned each of the three functions. By analyzing them according to different degrees of centralism and decentralization we can weigh the advantages and disadvantages of any combination of levels and functions.

2.2.1. *The stabilization function*

In this sphere, at least until very recently the conclusions of the theory of multilevel public finance have been clear and simple. It is the opinion of those scholars who admit the necessity or at least the usefulness of a stabilization function that it must be performed by the central government. Denied as they are the tools of monetary policy, local governments would have to rely exclusively on fiscal policy, *i.e.* spending, taxation and borrowing, to counter cyclical downturns and maintain employment at a satisfactory level. But for local government the use of fiscal policy itself is strictly limited. For the most part, in fact, local economies are very broadly open externally with respect to other areas, from which they acquire a large portion of the goods and services consumed. Therefore a policy of income expansion based, for example, on higher public spending by a local government would benefit its jurisdiction only marginally, as most of the expenditure would go elsewhere.[10]

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[6] Important exceptions are the MacDougall Report of 1977, which called for the division of functions within the Community in line with the principles of fiscal federalism, and the Padoa-Schioppa Report of 1987. Paradoxically, most of the recent contributions on the theme have come from Americans rather than Europeans: Sachs and Sala-i-Martin (1991), Krugman (1993), Eichengreen (1990, 1991), Eichengreen and Frieden (1993), Eichengreen and Wyplosz (1993), Inman and Rubinfeld (1991).

[7] Fiscal federalism is taken to mean a political system in which tax and spending powers are divided among various levels of government; the term "federalism" thus carries broader connotations than the federal state as such.

[8] All the more recent and up-to-date textbooks on public finance now include a chapter on multilevel finance and fiscal federalism. See, among others, Tresch (1981), Hyman (1983), Aronson (1985) and Cullis and Jones (1992).

[9] Ordinarily, these are considered as expenditure functions, but the determination of the optimal level of government also embraces the revenue side, *i.e.* optimal tax assignment (Oates 1990, p. 46). The seminal work in this field is Musgrave (1983). This topic is discussed further on.

[10] It would result in an increase in imports by the local economy. In Keynesian terms, this implies that the expenditure multiplier is quite small (Oates 1972, p. 5). Using a simple Keynesian model Oates (1968, pp. 40-43) shows how small the expansive impact of fiscal policy enacted at the local level is.

The constraint on the local government thus appears stringent indeed: it simply lacks any capability to stabilize its economy. The limit is all the more severe with respect to deficit spending by the local government. Recourse to debt at the local level entails a cost for residents that does not arise in the case of centrally issued debt. In an economy with high capital mobility, the paper issued by a local government inevitably ends up mostly in the hands of non-residents, which burdens the local economy with interest and repayment costs that will eventually have to be borne by residents. The national debt is chiefly domestic, but that of a local government will be very largely in the nature of "foreign" debt. Moreover, a local government does not enjoy the national governments' ready access to the national and international capital markets, nor can it adjust monetary policy, where this is still the responsibility of the national government, to facilitate borrowing. The strict conclusion of the theory of fiscal federalism is that it is the central government, not any local authority, that is best placed to manage the stabilization function.

2.2.2. *The redistributive function*

The theory's conclusion concerning the second fundamental function of government, namely the redistribution of income, is similar. The difficulties of any local authority in exercising it derive from the high mobility of individuals, capital and companies within the national territory. Any local government that undertook an independent policy of income redistribution through progressive taxation (or money transfers) would be faced with massive emigration of the wealthier groups and an inflow of the poor, the former being repelled and the latter attracted by income-levelling. Rather than producing a more equitable income distribution, the end result of such a policy would be a sharp reduction in per capita income within the jurisdiction. The smaller the community, the greater the potential mobility of residents, as is effectively demonstrated by the case of cities in the United States. And the greater the mobility, the sharper the constraint on locally instituted policies of income redistribution.

By contrast a central government, from whose jurisdiction the outflow of individuals is in general more limited, can successfully implement a reasonable redistribution of income. The larger the jurisdiction in geographical terms, and hence the higher the cost of

outward mobility, the greater the chances of success for a programme of income redistribution. The mobility of productive factors would impose the same constraint on local taxation of financial capital or industrial or commercial enterprises. For this reason local authorities generally raise their revenue via taxes on immobile factors such as real estate and sales taxes. The theory of fiscal federalism thus leads to the conclusion that the optimal level for any policy of income redistribution is that of the central government.

2.2.3. *The allocative function*

The purpose of the allocative function of government is to achieve economic efficiency in those cases in which there is a public good that the market cannot supply, *i.e.* cases of market failure. Essential to the attribution of this function is the spatial incidence of the benefits of the goods and services supplied by government; this incidence is at once a prerequisite for efficiency and the justification of a multijurisdictional (federal) structure. Optimal allocation requires that public services be supplied (and their cost shared) according to the preferences (the demand) of the residents of the beneficiary regions (Musgrave 1961, p. 9 and 1971; Musgrave and Musgrave 1973, p. 597). The political system, which through elections determines citizens' preferences, albeit imperfectly, should be designed so that those goods whose benefits are distributed equally over the population are provided at national level, while those with a specific territorial dimension are the responsibility of local jurisdictions.

It is the differential spatial incidence of the benefits flowing from different goods and services, then, that necessitates multiple jurisdictions, which in turn require a tax structure based on multiple units each covering a specified geographical area of a different size. If the public goods were all "pure", the problem of jurisdiction would be easily solved: they should be supplied by the central government and decided at national level (Musgrave 1971, p. 34). If this allocation were not instituted there would be incentives for free riding and the underproduction of "pure" public goods.[11] Unfortunately, very few public goods qualify as "pure"; for most, there is a geographically disparate incidence of benefits.

[11] One of the first studies on this topic is Olson and Zeckhauser (1966), on external defence.

The advantages of a decentralized system for the supply of public goods would appear considerable when there are differing preferences or sharp variations in benefit intensity between local communities. Relying on the central government would essentially result in highly uniform public services among diverse communities (hence, given the differences in demand, a loss of welfare), while local governments are better able to reflect the preferences of individual citizens concerning various spending and revenue policies.[12] The greater ability to comply with these preferences tends to produce greater economic efficiency.

There are other far from secondary advantages in the institution of a more or less broadly decentralized system of government. First, decentralization allows for greater experimentation and innovation in the supply of public goods. The existence of a large number of suppliers (the local authorities) not only ensures a variety of approaches and production methods, stimulating technical progress, but also makes possible competition among producers (more and more frequently these are private firms), fostering efficiency in production. Second, by linking spending decisions to effective costs, decentralization should attain more efficient levels of public output. For if the residents of a community have to pay for certain goods and services out of local taxes, the connection between costs and benefits is more evident and the fiscal responsibility of the local agency consequently greater, in contrast to an arrangement in which the financial resources for goods and services come from the central government and the local authorities, not bearing the cost, have an incentive to increase supply.[13]

However, the attribution of the function of supplying goods and services to local authorities is also subject to a set of limitations. There may be congestion in consumption and externalities substantial enough to offset the optimal allocation of resources. If people can move from one jurisdiction to another in order to consume public goods, then above a certain level consumer migration will entail overcrowding, thus diminishing both quality and quantity of those goods.[14] A solution to this problem was suggested by Buchanan (1965) in his famous work on the economic theory of clubs. The key concept is to set the costs of the congestion produced by a larger number of consumers against its benefits (the per capita cost reduction), thus determining the optimal size of the community. This can be defined as the population for which the marginal gain from one additional resident is equal to the marginal cost of congestion.

Where local supply of public goods and services produces positive or negative externalities for residents of other communities, then their production will either be suboptimal (if the benefits spill over into other local communities) or supraoptimal (if costs, such as local excise taxes, are shifted to non-residents via producer prices) (Oates 1968 and 1972, p. 46; Musgrave and Musgrave 1973, p. 521; Netzer 1974, p. 367). Going by the theory of fiscal federalism, the solution to the problem of interjurisdictional externalities consists in central government subsidies to or levies on the local authorities in order to internalize these diseconomies.

2.3. *Tax assignment*

Closely bound up with the assignment of economic policy functions is the assignment of the various taxes to the different levels of government: the question, to put it simply, of "who should tax, where and what".[15] Musgrave has laid down principles governing tax assignment for the various types of levy, both vertically and horizontally.

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[12] Oates and Musgrave, using Tiebout's classical "voting with one's feet" argument, pointed to a second economic reason for a multilevel government structure: while uniform supply of a good at the national level requires compromise between individuals (who may have differing demand for the same good), at the local level the geographical mobility of individual consumers might enable them to select the fiscal package that best satisfies them. This voting with one's feet, it is argued, thus permits the efficient allocation of resources. However, later theoretical and empirical studies have shown just how severely restrictive are the assumptions of Tiebout's model (above all, see Brosio 1994a, p. 109), such as to make the model itself highly unrealistic, and how it abstracts from other fundamental political and social considerations, such as ethnic identity and traditions, language, religion and culture.

[13] Musgrave and Musgrave (1973, p. 605) cite other important reasons for decentralization, such as the improved likelihood of social integration of citizens by their participation in local decisions and the threat to civil liberties implicit in an overcentralized government.

[14] The traditional examples, in the case of neighbouring jurisdictions where transportation costs are negligible, are public parks and swimming pools. These are the classic "local" public goods, which is to say goods whose benefit to individual consumers depends not only on the amount consumed but also on the number of individuals who consume it.

[15] Musgrave (1983); for discussions, Musgrave R. (1969b, 1971), Musgrave P. (1987), Spahn (1993, pp. 71-78), Brosio (1994b, p. 68).

The taxes that should be assigned[16] to the central government are: *a)* progressive income taxes and taxes on highly mobile productive factors, to prevent "fiscal flight" and distortions in plant location decisions; *b)* those taxes levied on bases distributed unevenly among jurisdictions, such as natural resources.

Note that by this standard (and in accordance with the distribution of functions described earlier), taxes with the potential for economic stabilization and income redistribution are assigned to the central government.

The taxes devolved on sub-national level are: *a)* taxes on bases that are immovable or difficult to transfer to other jurisdictions; and *b)* taxes related to a spatially limited benefit, such as the public prices and charges for goods supplied locally.

In short, under these principles individual income taxes, company taxes, and excise taxes should basically be assigned to the central government, which could also appropriately enjoy the proceeds from centrally provided goods and services. General taxes on consumption, real estate taxes and prices and tariffs for local public services are the most suitable sources of revenue for lower levels of government.[17]

2.4. *Federalism*

Since it is the conviction of some that Europe is already a protofederal state and the intention of many that this degree of federalism shall and must develop, it is worth inquiring into the concept of federalism, which is narrower and more defining than fiscal federalism or multilevel government. One should not marvel at the interest in federalism demonstrated by economists: Oates (1977b, p. 4 and 1977c), for instance, notes that "federalism" should not be interpreted in strictly constitutional terms but should also be read in an economic sense.

[16] Spahn (1993, p. 71) rightly points out that in considering tax assignment among levels of government one could distinguish between the authority to "consume" the tax revenue, that to legislate on tax matters and that to administer the taxes. As a rule only the first two, held to be the most important, are considered.

[17] This assignment essentially adheres to the criteria of efficiency and equity. If in keeping with the theory of multilevel public finance one adopted the principle of benefit exclusively, then every level of government should have taxing authority of its own to cover on the geographical distribution of the benefits of its action (Spahn 1993, p. 72).

If one adopts a very broad and elastic definition, as we did for fiscal federalism, then all governments, even strictly unitary ones, are in principle federal, in that all give rise, in different measure, to forms of financial and administrative decentralization. It is accordingly difficult to distinguish, within the genus of multilevel governments, the species of federalism. Obviously to an economist the structure of government, its lesser or greater decentralization, is relevant essentially for the effects it may have on the allocation of resources and the distribution of income; and in particular, on how the supply of goods and services can be adapted to the preferences of the various communities that inhabit the territory. But if we define a federal system as a public sector with both centralized and decentralized levels of decision-making in which the provision of public services by the various levels of government is determined largely by the demands of the residents of the respective jurisdictions (Oates 1972, p. 17), then we are unable to distinguish the species from the genus.

Nor do we find assistance in Musgrave, who holds (1969a, p. 521) that federalism means different things to different people and is not an unequivocally defined concept. In this view there is no distinct theory of federalism with a definite division of functions among levels of government that applies universally; instead there are various models characterized by different degrees of decentralization. Federalism thus ends up embracing a composite of theories and examples, resolving the dilemmas of function assignment in not necessarily a consistent fashion.[18]

To political scientists, a significant distinguishing feature of federalism is the existence of specific constitutional precepts safeguarding the autonomy of the various levels of government. Keeping within the precincts of economic policy and accordingly leaving aside formal legal elements, one must recognize that in practice there is far from perfect and stable correspondence between the jurisdiction providing and the citizenry demanding a particular combination of public goods, that the political machinery for revealing preferences does not always work well, that over time each jurisdiction tends to collide with those above and below it in an effort to extend its sphere of power, often invoking economies and diseconomies of scale, positive and negative externalities.

[18] If one accepts such an elastic definition then even present-day Europe, with its incongruencies and half-completed projects, can be considered an example of federalism, a largely unfinished instance that has sought for the last thirty years to achieve more mature forms of political and administrative integration.

Consequently there is a more or less continuous process of negotiation and renegotiation between the different levels of government.

One may posit two ideally typical forms of political organization, the one-government system with complete centralization of functions and the totally decentralized system, as the extremes of a continuum along which are located the various political and constitutional combinations of the two factors.[19] Over time, the renegotiation of powers tends to shift any given system towards one extreme or the other, sometimes in a pendular pattern of action and reaction.

In our view, in order to specify federal systems within the genus of multilevel governments, one must make definite assumptions concerning the bargaining power of the highest level of government as against the others. Federalism, that is, is defined not so much by the form of political organization (the constitution, which ensures the formal stability of the structure itself) as by a large degree of decentralization in the allocation of resources and in the provision of goods and services, and above all by the central government's lack of the authority to alter relations between itself and the lower levels.

If the population is heterogeneous, but made up of relatively homogeneous subsets, then choices will be differentiated and the federal model is more justified. If the population is relatively homogeneous, then the key is local supply and local participation, and there are solid grounds for simple decentralization of the provision of goods that are locally differentiated only in quality and mode. Thus the essence of federalism is allowing different groups living in the various jurisdictions to express sharply divergent preferences with respect to public goods and services, and this inevitably entails differences in the intensity of the citizenry's involvement in public affairs and in tax and spending levels. However, if the intention is to distinguish federalism still more clearly among multilevel government systems, one cannot rely on the principle of equivalence (perfect correspondence) between the jurisdiction that supplies a particular good and the community that demands it. It is necessary to consider the relative power of the various levels of government, and in particular the absence of overwhelming bargaining power for the central government as against lower levels, its inability to change the rules of the game. This will certainly be the case of the European Union with respect to its member states.

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[19] The mix of more or less centralization may have two alternative extremes: a state of anarchy (absolute decentralization) and Leviathan (absolute centralization).

3. A model of multilevel public finance for the European Union

3.1. *The European Union and other federal experiences*

According to the theory of finance in a multi-jurisdiction framework (or, in the shorter and more fashionable term, "fiscal federalism"), the effort to construct a federal union in Europe must identify the optimal levels of government at which to perform the economic policy functions discussed earlier as well as a way to reconcile these with the spontaneous working of the market.

We must be realistic about the possibility of applying fiscal federalism in Europe. The enormous differences between the European Union and existing federal countries raise the question of whether that model is really relevant, whether it can be helpful in planning the stages of development towards a full-fledged federal system in Europe, an outcome to be hoped for but of which there is no assurance. Europe has unique economic, political and constitutional characteristics that sharply limit the relevance of the main implications of the theory of fiscal federalism, at least in the short run. Nevertheless, these indications may ultimately provide notable support in the step-by-step design of European institutions.

The theory of fiscal federalism is essentially static: that is, it tells which level of government within any multilevel system, including a federal system, is best placed to perform certain tasks; but it is no great help in analyzing the dynamics of federal structures in the process of creation, their formation, the stages by which the transition may be accomplished. In theory, the principles of European federal finance should be determined, in each phase of the Union's development, by the assignment of the functions to the various levels of government. The stages themselves may be sketched out as follows: *a)* with the single market, a certain degree of monetary and fiscal policy coordination (given the exchange rate mechanism) is sufficient; *b)* in the pre-federal stage, the much closer coordination of monetary policies, through the European Monetary Institute, and of fiscal policies becomes necessary; *c)* in the proto-federal stage, with Monetary Union, a European Central Bank and a single currency are required; *d)* the stage of federal consolidation demands the enlargement of the federal budget and the assignment of more specific stabilizing and redistributive functions, the institution of new community policies and of European taxes; *e)* the completion of the Federal Union in many other directions is for the final stage.

Moreover, the theory of fiscal federalism is drawn from the study of mature federal unions, which have government units at various levels with autonomous and usually very well-defined powers; this is not yet the case of the European Union.[20]

Institutionally, there are at least two crucial differences between established federal states and the European Union in its current situation. First, the Union still has no well-defined structure with a consolidated central government. Its organs of government, though endowed with some spending and revenue prerogatives, are not independent of the member states and do not yet possess the functions that are generally exercised by the central government in federal systems (defence, foreign policy, budget, etc.). Second, the European Union is not yet an area with a single currency, unlike its member states (Oates 1977a, p. 285) or long-standing federal states, though we can hope that it becomes one by the end of this decade.

For more than two decades Europe has been working, in the studies of the Commission and of economists, to define some principles of federal finance. In this effort the theory of fiscal federalism may nonetheless form a useful starting point, albeit with certain necessary modifications and innovations, for the design of a federal financial structure specific to Europe. Economic theory may be of great assistance to policy makers in making decisions, although it cannot act as a substitute for political will and imagination in planning the stages of federal development for a group of countries (Padoa-Schioppa 1993, p. 55).

The Maastricht Treaty has not terminated discussion. If anything, it has sparked a renewal of the debate on governmental powers within the European Union and their division among levels. The concept of subsidiarity, invoked by the Treaty from its opening lines, is essentially empty. Following Oates's theorem, the principle of subsidiarity holds that decentralization is preferable unless there are compelling reasons

[20] The institutional framework for the theory of fiscal federalism, naturally, is an existing, well-defined federal entity, with a central government and one or more local government levels (Oates 1977a, p. 284). This federal entity constitutes an area with a single currency within which the central government has full fiscal authority: spending capacity, tax power and, finally, the ability to issue debt. The tax and spending powers assigned to local governments, though important, are residual, and they must in any case be coordinated by the central government or harmonized with it.

for centralization.[21] But the concept does not determine which functions should be performed at any given level or establish the reasons for differing degrees of centralization.

One cannot ignore the enormous differences between established federal systems and the European Union: the Continent's political, linguistic, cultural and religious differences are more pronounced and certainly much more deeply rooted than those of existing federal countries.[22] Such radical divergences clearly demand great caution and imply a need to modify the traditional assignment of government powers effected in such countries as Canada and the United States, adapting it to the specific conditions of the European Union. Even the most superficial comparison reveals, first of all, that the American single market is much more highly integrated; second, that the United States enjoys a mobility of capital, firms and labour that is markedly incomplete in Europe; and finally, that U.S. industry is much more highly specialized at the regional (state) level. For this last reason, significant changes in the demand for products, especially for a region's exports, produce very severe regional shocks, which are buffered thanks to the substantial federal budget (Sachs and Sala-i-Martin 1991; Inman and Rubinfeld 1991; Krugman 1993).[23]

Although a single currency would eliminate exchange rate variations, stabilization policy must still allow for the marked imperfections of the European labour market[24] and the greater difficulty of the goods markets in spontaneously finding equilibrium. If an inelastic national labour market is subjected to macroeconomic shock, rigid nominal wages and poor labour mobility can transform unemployment that is partly structural into an army of unemployables. Moreover, the mechanisms of spontaneous adjustment are slow and imperfect, so that

[21] For a discussion of the concept of subsidiarity, see CEPR 1993, p. 3. A summary definition would be as follows: the intervention of the highest level of government, the Community level, is allowable only when there are economies of scale and externalities between member countries that cannot be satisfactorily resolved by policy coordination among national governments (Bureau and Champsaur 1992, p. 89). See also Emerson *et al.* (1992, p. 33) and Sinn (1993).

[22] In the United States, for instance, until very recently the melting pot powerfully attenuated the linguistic and cultural identity of the various ethnic groups despite mass immigration.

[23] Other major differences include the linguistic unity of the U.S. (now partially undermined by the spread of Spanish) and the shared social tradition of migration.

[24] It is well known and solidly established empirically that labour mobility is much lower in Europe than in America (Eichengreen 1991; Krugman 1993).

such an exogenous shock would eventually have repercussions on real economic variables (Majocchi 1993; Majocchi and Rey 1993).

If Europe is consolidated as a great market without barriers to the movement of men and women, capital, goods and services, and all the more so if the Union advances decisively along the road to full-blown federalism, then we can very likely expect a number of developments: *a)* a sharp accentuation of the regional specialization of industry as the result of economies of scale in different countries and areas; *b)* heightened variability of individual countries' exports and trade balances; *c)* an increase in capital mobility and its procyclical effect; and *d)* a significant divergence in long-term growth rates between national economies (Krugman 1993, p. 242).

If this is the course of development, there will be an increased risk of asymmetric shocks between countries; the role of the Union budget and common fiscal policy will be accordingly crucial, with the triggering of built-in or discretionary stabilizers, unless the policy makers of the Union are so thoroughly monetarist as to deem such programmes useless or worse.

3.2. *Economic stabilization*

Maastricht laid down the basic mechanisms, convergence processes and stages for the creation of the European Central Bank and a single currency. Notwithstanding the recent difficulties, there is no alternative to holding fast to the agreements and principles established and moving ahead along the route traced out without calling the Treaty into question.

On other occasions we have examined the nature, operating rules and essential characteristics that should distinguish the future European Central Bank (ECB),[25] but the main features are worth briefly recalling. First, the ECB is bound to the objective of price stability. Second, its statute accords it full independence from national governments and the other bodies of the Union. If this were not the case, governments could employ inflationary monetary policy as a hidden form of taxation and thus circumvent the legislative power to which tax authority is rightfully assigned (Sarcinelli 1992, p. 149).[26] Third, the central bank functions of lender of last resort, guarantor of the

[25] Sarcinelli (1990, 1992 and 1993). See also Cesarano (1992).

[26] Realistically, however, we must remember that money supply management has never been successfully separated from politics (Sarcinelli 1990). As a rule events in the

payment system and above all banking supervision are in no way secondary to that of ensuring monetary stability (Sarcinelli 1992, pp. 155-164).

However, the construction of monetary union also envisages certain entrance requirements for the member states: limits on the relative size of budget deficits and the public debt, interest rate requirements and participation in the exchange rate mechanism, and inflation differentials. In addition to achieving greater convergence among the European economies, these constraints were intended to guarantee stability of the monetary union[27] by removing obstacles to the proper working of the European Central Bank.

The rise of a monetary union designed for price stability and having an independent central bank for the purpose takes away one of the two instruments used by national governments for conducting economic stabilization policies. Moreover, the constraints of the Maastricht Treaty set stringent conditions on the use of the other instrument of real economic stabilization, namely fiscal policy. Thus the role of fiscal policy in Europe is doubly bound to the plan for Monetary Union. With exchange rate and monetary manoeuvres out of bounds, alternative tools for countering exogenous shocks must be found. For as is well known, in economic unions some national (*i.e.*, federal) stabilization policy is a necessity.[28]

Yet if the goal of monetary unification as laid down in the Treaty is attained, by comparison with existing federal systems the European Union will have a highly peculiar, asymmetric structure. Monetary policy will be central, while fiscal policies will be absolutely decentralized: though subject to constraints on certain tax rates, on deficits and the volume of public debt, they will not necessarily be coordinated to cope with the economic cycle or respond to any specific shock.

Thus the use of fiscal policy for economic stabilization raises a number of questions. First, one must distinguish between symmetric

political and economic sphere ultimately influence the action of the central bank, but the structure and decision making machinery of the future ECB will prove decisive for the independent pursuit of price stability.

[27] For example, by eliminating the risk that an excessive budget deficit in one country could put pressure on the central bank for monetary financing of the deficit. See Giovannini and Spaventa (1991).

[28] See Mundell (1961), Oates (1972), MacDougall (1977), Padoa-Schioppa (1987), Eichengreen (1990 and 1991), Sachs and Sala-i-Martin (1991), Eichengreen and Frieden (1993), Bayoumi and Eichengreen (1993), Eichengreen and Wyplosz (1993), Krugman (1993), Goodhart and Smith (1993).

shocks (connected with the business cycle), which affect all the states or regions of a federation more or less simultaneously, and asymmetric ones, which affect only some national or regional economies.

In the case of specific shocks, if there were very high labour mobility, adjustment could be achieved by changes in output volumes, or, if there were near-perfect price flexibility, through changes in nominal prices. Prices and costs would thus move to a new full-employment equilibrium.

The third, more realistic way of absorbing such shocks in a single-currency regime is that followed by existing federal systems (notably the U.S.), namely effective fiscal and stabilization policy at the national level, *i.e.* the institution of a tax and transfer system that operates largely automatically an income redistribution in favour of states hit by asymmetric shocks. This is especially relevant to Europe, where as we have seen labour mobility is poor and prices and wages very "sticky" downwards.

If the mobility of capital in Europe is very high, that of labour is unquestionably very low. Owing to historically, linguistically and religiously rooted attachment to their native territories, Europeans are reluctant to move, especially if wage differentials do not respond to changes in relative scarcity.[29] Thus, in our view, the transfer of resources from the more affluent or less hard-hit regions to the less affluent or more severely affected will be essential. The justification for such transfers to the regions within a monetary area that are asymmetrically hit lies not only in the fundamental principle of solidarity but also, in more strictly economic terms, in the fact that the lack of exchange rate movements reduces the welfare of such regions. Grants are obviously needed to compensate for the residual imperfection of the labour market, but they must act as complement to factor mobility and wage flexibility, not as the substitute for one or both.[30]

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[29] In the future, a major effort will be required to remove the impediments to mobility within the Community, first and foremost by reducing the costs of transportation (air fares, etc.) and of establishment (housing and real estate).

[30] The Padoa-Schioppa Report (1987) warned that if monetary integration moved to a more advanced stage, there would be a need for fiscal policy action at the Union level much ampler than that allowed for by mere coordination of national policies. Sachs and Sala-i-Martin (1991) contend that a fiscal policy for Europe is utterly indispensable to the construction of a viable monetary union (see also Emerson *et al.* 1992, p. 103). These authors argue that the large federal budget is what explains why the system of "fixed exchange rates" (the single currency) has worked so well in the United States over time. It made it possible to buffer the disequilibria afflicting various regions and prevent them from threatening the monetary stability of the nation.

Just because the Treaty of Maastricht does not provide for increasing the Union's budget and the efforts of Jacques Delors as Commission Chairman subsequent to the ratification of the Treaty were not crowned with full success, one must not jump to the conclusion that the Economic and Monetary Union will unavoidably be beset with difficulties from its first day of life as a single currency area and that accordingly in 1996 we will have to reopen the Pandora's box of negotiations that led to the treaty in the first place. Let us recall that asymmetric shocks will grow more frequent only if the exploitation of economies of scale sharply accentuates the regional specialization of industry, destabilizing exports and regional trade balances. For this to happen, however, Monetary Union must already have been in place and working for some years and have demonstrated special effectiveness in giving rise to the territorial reallocation of industrial capital. There will be time enough, therefore, to work on extending the fiscal authority of the Union to safeguard the operation of the single currency area. This is no cloth of Penelope that we must rush to reweave.

Since the monetarist revolution does not appear to have relegated economic policy to the attic but only eroded confidence in the economic intervention of government, in the case of cyclical shocks too it would be theoretically preferable for the federal budget to take direct stabilizing action. Desirable as this may be, however, in the short run the small size of the EU budget makes it impossible.[31] The Union's limited financial resources, barely 1 percent of the area's GDP, and the rules governing the budget process would suggest that the only possible role for the Commission in managing stabilization policy is to stimulate fiscal policy coordination between the member states. Necessary as such coordination is, however, if nothing else simply to prevent national fiscal action from counteracting economic stabilization for the Union as a whole, it is distinctly less than satisfactory. For coordination means delay in the activation of stabilization measures, which can be their undoing. What is more, there is the known risk that coordination may result in overshooting, such as an unwanted deflationary impact when all countries restrict their fiscal policy stance without allowing for the domestic economic effects of such simultaneous, multilateral action.

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[31] For a discussion see Majocchi (1993, pp. 21-22), Rey (1993) and Majocchi and Rey (1993).

On the other hand, a stabilization policy conducted directly by the Union through its own fiscal policy further implies a major increase in the size of the budget, the reform of the budget process and the revision of its operating rules (Majocchi 1993, p. 23; Rey 1993, p. 75; Majocchi and Rey 1993).[32] First, there should be a cautious relaxation of the balanced-budget rule (to make the Union's fiscal stance more effective as a built-in countercyclical stabilizer) and the attribution to the Union of limited power to contract debt. Second, a European system of grants and countercyclical funds should be instituted.[33]

In a word, unless the EU budget is substantially enhanced in size and flexibility, it is pointless to ask which level of government should undertake the stabilizing function and by what procedures (and the same goes, in part, for the redistributive function).[34]

Anyway, in a fully mature Monetary Union with a single currency, economic stabilization could always be undertaken at first through coordination of national fiscal policies, even though this is sub-optimal. One must bear constantly in mind that the construction of the European edifice does not correspond to a blueprint minimizing intertemporal costs. Rather, it is the result of efforts to achieve what advance is practicable towards an objective that history has allowed us to glimpse but not yet to grasp.

3.3. *Fiscal redistribution*

In theory there is no objection to the proposition that the redistributive function should be assigned to the highest level of

[32] Majocchi (1993, p. 24) calls for enlarging the responsibilities of the budget authorities, such as the European Parliament and the Council of Ministers, to which power of decision over expenditures and their financing should be assigned.

[33] The experiences of other federal systems highlight the great importance of the public finances in moderating short-term cyclical fluctuations (Rey 1993, p. 61). Variations in tax revenues and expenditures offset between half and two thirds of a region's income loss (Sachs and Sala-i-Martin 1991). The need for a substantial Union budget follows from the fact that the more open and integrated the member state economies are, the less effective the employment of economic policy instruments at the national level will be. Majocchi and Rey (1993) have proposed the creation of a regional cyclical convergence fund and a Community unemployment fund.

[34] The MacDougall report saw the necessity of a sizable increase in the Community budget in the pre-federal stage (to at least 2.5 or 3 percent of GDP) to make possible the conduct of some policy of stabilization and redistribution. However, substantially increasing the financial resources devolved on the Union accords ill with the large government deficits of some member states, which severely constrains their freedom of manoeuvre and would also have to overcome the refusal on the part of some members to attribute any major expenditure function to the Union.

government, the federal level, in that regional measures are necessarily ineffective where individual mobility results in the emigration of the affluent and an effective preference on the part of the poor for regions where fiscal policy is more markedly redistributive.[35] However, this principle is subject to significant qualifications. Goodspeed (1989) demonstrates the possibility of conducting major redistributive policies at the regional level with very little loss in efficiency; Epple and Romer (1991) show that significant redistribution at the local level is theoretically possible; and Perotti (1993), in a particular context, underscores the preferability of local redistributive measures.[36]

From our standpoint, the question is whether given the low mobility of individuals within Europe it may not be advisable for the member nations to retain specific powers over the redistribution of personal income. The argument for such an approach draws strength from the fact that so far the European Union has experienced equalization between regions with extremely disparate per capita incomes but not very much between states. If the more disadvantaged regions of Europe are to catch up, the Union will have to ensure high factor mobility, real wage flexibility (to reflect productivity differentials) and effective mechanisms for government resource transfers. The latter requirement would be unnecessary if the labour market were perfect, but that is not of this world. If not impeded by burdensome constraints and regulations, the market can provide the first two of these conditions but not the third. Yet the debate at the European level focuses precisely on the proper dimensions of this transfer function.

The size and action of the structural funds are familiar enough to require no detailed treatment here.[37] Naturally, the Community's limited budget rules out any extensive redistributive action by the Union. Nevertheless, while small in proportion to European GDP, in the case of Greece and Portugal the transfers have amounted to a significant share of the recipients' national income (around 3 percent).

The criteria for tax assignment in multilevel systems of public finance (Section 2.3 above) are broadly based on the experience of fully

[35] As Musgrave says, "Fiscal redistribution – both progressive income taxation and transfers – must be uniform within an area over which there is a high degree of capital and labor mobility: that is to say, it has to be a function of the national government".

[36] For a discussion, see Marè and Perotti (1995).

[37] For a recent analysis, see Gordon (1992).

developed federal systems and in particular of the United States (Spahn 1993, p. 71), and it is accordingly inappropriate to apply them mechanically to immature systems like the EU. What is more, at least in the medium term there appears to be little risk of national progressive income taxes prompting massive migration of individuals. Tiebout has yet to penetrate European civic consciousness, and people are still firmly rooted in their home regions and countries, with binding linguistic, cultural, historical and family ties.

Nor is it certain, even on the theoretical level, that Tiebout's model of individual mobility and inter-jurisdictional competition will always produce greater efficiency. Epple and Zelenitz (1981), for instance, show that competition among a large number of jurisdictions is insufficient to ensure the efficiency of the public sector, while Oates and Schwab (1988) note the many distortions arising from competition among local authorities.

If many factors of competition (such as tax regimes for capital and goods) are already at work fostering ever-increasing downward convergence among countries, Europe is still marked by its scant labour mobility. One immediate consequence is that as long as this persists personal income taxes will not be the object of fiscal competition and will continue to be a stable source of finance for national programmes of income redistribution. Not until integration is very far advanced and many of the barriers to individual mobility have been removed (transportation and establishment costs, housing and job search costs), can part of the redistributive function be reassigned to the federal level of government.

In conclusion, today the action of the Union constitutes a modest supplement to that of the member states themselves. The presumable characteristics of the federation in the near future do not permit any conclusion other than the assignment to the member state of responsibility for interpersonal income redistribution, with the Community merely complementing the member countries' efforts at interregional equalization.[38] It would take a powerful surge of European spirit and action to impart momentum, over time, to efforts for more significant federalization of some aspects of the redistributive function.

[38] Let us recall, in this context, the particular experience of the German *Länder*, which carry out significant horizontal redistribution, with transfers from the wealthier *Länder* to the poorer, but not vertical. On the assignment of the redistributive function, see Tresch (1981) and Rimini (1993, pp. 152-158).

3.4. *Allocation*

Assignment of the allocative function of government should ultimately conform to the essential condition laid down by the theory of fiscal federalism: that public goods be provided (and their cost shared) in accordance with the preferences of local residents and the territorial incidence of the benefits. However, this division of responsibilities requires not only compliance with the rules of competition but also avoidance of wasteful duplication in the provision of goods and services[39] and harmful forms of strategic competition (subsidy wars).

There is another important consideration, however. The recent moves to cut back the size and scope of the public sector through privatizations will eventually mean a significant reduction in the number of publicly provided goods and services. In response to widespread criticism of public intervention and of government as economic producer or administrator, what were once the essential constituent elements of a federation, *i.e.* natural monopoly services (railways, electricity, the post office, which played a historically decisive role in the territorial unification of both federal countries like the U.S. and unitary states like Italy or the U.K.), have been partly delegated to the market. Given the prevalent opinion that the best government is the least government, with many public functions being transferred to market forces and prices supplanting taxes, the number of public goods offered by the various jurisdictions shrinks, and with it the scope of government action. But obviously, the greater the number of goods supplied by government, the stronger the rationale for fiscal federalism. Moreover, the operation of fiscal federalism will certainly be less conflict-ridden when there is no jurisdictional overlap in providing goods.

While from the standpoint of resource allocation, shifting responsibility for defence and diplomacy to the Union is not merely justified but natural,[40] in practice it remains difficult, controversial, anything but straight-forward, the guidelines laid down at Maastricht notwithstanding. The reason is that the construction of Europe now depends on the convictions of leaders and the interests of peoples as

[39] The classical example in the United States is the provision of different law enforcement security and police services at different levels of government.

[40] On the reasons for common European defence and its economic benefits, see Marè (1994).

they are perceived and politically mediated, no longer on the fear of Communism. The sad, bloody demise of Yugoslavia bears eloquent witness to the difficulty of finding a common line of conduct in foreign affairs in time to react to sudden developments, as is indispensable in the international arena. Unfortunately, history is replete with instances of constitutional change brought on by war or revolution, virtually devoid of cases of such change through democratic persuasion. Despite the failure of the European Defence Community in the 1950s, in radically different historical circumstances, there is no reason to give up hope or abandon trust in the light of reason.

3.5. *Strategies for federal integration: competition or coordination?*

As matters stand, there are essentially two political strategies for European integration: that of institutional competition and that of coordination, implying some degree of centralization and some degree of independent power for the member states in the key policy spheres.

Not only federal systems but also multilevel systems within unitary states have complex mechanisms, a delicate balance between central and local power that is continuously redefined as the pendulum swings back and forth between centralization and decentralization. Recent history offers a vast array of irresistible surges of decentralization, leading to the extinction of a number of federal states: the USSR (suddenly and unexpectedly), Yugoslavia (violently), Czechoslovakia (civilly and democratically). We have also witnessed the rise of powerful separatist pressures: Quebec and Alberta in Canada, Western Australia (Brosio 1994a, p. 99).

The cornerstone of a federal state is the contract between the different levels of government. But there is no single arrangement, no optimal contract between lower levels and the federal government. Nor is the contract immutable; rather it is continuously reinterpreted if not formally renegotiated between the parties. It is only natural, therefore, for there to be forms of vertical cooperation between different levels of government and also horizontal cooperation, as well as both vertical and horizontal competition. Within the Economic and Monetary Union the Maastricht Treaty establishes the principle of subsidiarity. Despite the ancient roots of this concept, which can be traced to Thomas Aquinas, it does not appear to have any specific

operative content. Actually, more than anything else it appears to be an ingenious way of placing the burden of proof in "federalization suits" on the central authority.[41]

The need for some sort of vertical cooperation (first and foremost, of coordination) should be self-evident. If there is not at least some objective common to the different constituencies, it is hard to see why there should be a federation in the first place. This collective interest is the *raison d'être* of the federal state, the essence of its being, the source of expectations for its survival. Yet the federal compact also draws vitality and strength and finds its economic purpose in the operation of institutional competition between central and local authorities and between local authorities themselves. This seems to be the Commission's strategy, and many recent EU policy initiatives have been consistent with it. For instance, in harmonizing VAT no range of possible rates change was set; instead it was decided to set two minimum rates (a downside threshold) and to allow the member states to select national VAT rates. The choice, in other words, was for limited competition.

However, vertical competition between central and local government does not always produce desirable results.[42] Policy enacted at lower levels may run counter to that of the central government, either deliberately or involuntarily producing contrary effects;[43] in such cases corrective action by the central government is required.

Competition between agencies and governments at the same level appears more beneficial.[44] For these benefits to be realized, however, several special conditions are required. One is that the competing local governments not be lopsidedly unequal in size, hence in economic strength (spending power and tax base). And even when competition between governments at the same lower level is allowed, central government action is needed both for financial and resource equa-

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[41] See CEPR (1993) and Sinn (1993).

[42] Let us observe in passing that vertical competition is the premise to questioning the principle of subsidiarity: one can imagine agencies at different levels separately deciding a given policy, and competing for the assignment of the relevant power on the basis of their performance.

[43] Brosio (1994a, p. 107) cites education, for instance where local school policy may conflict with goals of income redistribution pursued by the central government.

[44] A very strong recent case for this type of institutional competition is made by Siebert and Koop (1993, p. 16). See also Breton (1987) and Salmon (1987).

lization (through government transfers) and for regulation and coordination (Brosio 1994a, pp. 111-112 and 117).[45]

Some further qualification of the role of competition is also required, however. First, it is neither simple nor proper to transpose the dictates of competition between economic agents in the market-place to competition between institutions, which are ruled by a different rationale and different purposes. Second, in order to work properly the competitive model requires high factor mobility, which cannot be said to prevail in Europe, and the absence of inter-jurisdictional externalities, also far from certain. Third, it seems to us that such competition should take place not vertically so much as between government authorities at the same level. And competition between small, local units is more productive than that between major regions or national governments. The risk is that countries will be forced into a practice of strategic competition (in the spheres of taxation, subsidies, environmental regulations, etc.),[46] driving such programmes below the optimal level and thereby diminishing the welfare of the entire Union.[47]

There is the further risk, moreover, that competition between institutions and countries may lead to a multispeed Europe,[48] a Europe of clubs. That the countries of Europe are advancing toward common objectives at differing speeds is undeniable and to an extent unquestionably natural. Unfortunately, this can be ascribed to the still scant convergence between the conditions of the member states, such that in the immediate future there is no avoiding a broadly diversified strategy. Yet we must recognize that instead of furthering convergence such a strategy could widen the gaps between the member economies. The risk is that this model for Europe, rather than produce compatibility between national economies and institutional arrangements, could exacerbate existing divergences and defer the prospect of a federal union, perhaps definitively.[49]

A stronger Europe, endowed with a solid core of centrally-administered federal policy programmes, even if few in number, could rely on healthy institutional competition, which is unquestionably necessary in such spheres as the labour market, agriculture, industry, natural monopolies and telecommunications, while leaving other areas (such as consumption taxes) to independent national policy-making.

To conclude, in certain areas "more" Europe is needed, in others "less". The fields in which a larger role for the Union is desirable are those in which the purity of the public good to be supplied is greatest: defence, environment, monetary management, continent-wide infrastructural networks, competition policy, the taxation of income from capital. These are fields in which the benefits of the good provided are not limited to the national level but extend well beyond the borders of the single member state.

4. Fiscal decentralization in Italy: a gloss

A federal reform of the Italian state or at least of its fiscal system has been called for in a number of quarters. Assuming that the electorate supports such a transformation, the scope of the necessary reforms must be calibrated on the basis of results achieved and the parallel but inverse tendency to a federalization of the European Union. For an accentuation of the federal character of the Union will severely constrain the scope for individual member states to advance towards more pronounced federalism or political and administrative decentralization.

Some European states are already federal in structure. Others, such as Belgium, have recently instituted far-reaching federal reform or, like Spain, are on the verge of it. Still others are decentralizing many of the functions that were once the preserve of the central government, as in France, where some national government insti-

[45] Another argument by advocates of competition (in the well-known thesis of Olson) is that it could reduce the extent and the costs of rent-seeking by the various national interest-groups, which harmonization from the top tends to breed.

[46] Recent developments concerning the harmonization of taxes on investment income, VAT and public subsidies to businesses stand as partial confirmation of this risk.

[47] The clearest instance is tax competition between European states. For an analysis of corporate taxation, see Giovannini (1989 and 1990); on VAT, see Sinn (1989) and Marè and Sarcinelli (1991).

[48] "Multispeed" Europe refers to time differences between countries in the achievement of objectives that remain common to all. If diversification involves the objectives themselves, then the proper term is a "variable-geometry" Community, an extreme version of which has been tagged "Europe à la carte".

[49] For a critique of the two-speed approach, see Alesina and Grilli (1993).

tutions are being relocated from the capital to other cities such as Lyon. The present period of transition and uncertainty at the European level thus coincides with a radical transformation of the structure of central and local government in most of the member states.

The national states are consequently subjected to two sources of pressure to diminish their authority and powers: from above, seeking to transfer sovereign functions to the supranational Community level, and from below, seeking to streamline the central government by assigning part of its powers to local units. This dual erosion of the function of the national state has led some to theorize a "Europe of Regions" (Drèze 1993), forgetting that the modern nation-state is the foundation of European political history, the product of half a millennium of development, and ignoring that if managing a Union of 15 or, in the future, 20 states is hard, making Europe work through direct links with several hundred regions is simply out of the question. In our opinion, the national state will remain the driving force of Union.

In Italy, since the tax reform of the early 1970s local government has been characterized by mounting fiscal irresponsibility. The Italian system of local autonomy has coupled the decentralization of spending power with the practically total centralization of revenues in the hands of the central government. Here, with no claim to exhaustiveness, we intend to recall a few of the issues that are decisive for fiscal decentralization in Italy.[50]

Apart from the single currency, a salient feature of the Italian economy is its very high factor mobility, and especially capital mobility. The country also has a multilevel government structure. Each of the four present levels has specific policy, administrative and economic responsibilities, though these have mostly remained a dead letter or been befogged by inter-institutional conflict. We shall seek briefly to identify a few standards that we feel should inspire efforts to achieve effective political and fiscal decentralization.

One principle is that each level of government should, in theory, be financially self-sufficient. Of course this standard does not preclude transfers from higher to lower levels for purposes of reducing regional

[50] For analysis and proposals, see Giarda (1994), Fondazione Agnelli (1993), CNR (1994), Patrizi and Rossi (1994), Tremonti and Vitaletti (1994) and Boldrin and Rustichini (1994).

disparities or equalization between local governments with differing resources and financial capacity.[51]

To ensure compliance with the budget constraint, in our view no recourse to debt on the part of local authorities to cover current expenditure should be permitted, even on an extraordinary basis. Any such course would aggravate the financial disequilibria and fiscal irresponsibility of the local governments, at additional cost to the national government. Temporary budget deficits could be envisaged only if ordinary bankruptcy procedures under the civil code were applicable to local governments, for this would prevent the consequences of local financial mismanagement from being shifted onto the central government, as they always have been in the past, while obliging lenders and investors to assess the local government's creditworthiness. Obviously borrowing capacity, for such things as local public works, would be limited by the local government's own resources and its untapped "reserves" of tax power.

A second principle is that of specifying the financial resources, *i.e.* the type of taxes, to be devolved on local authorities to fund benefits and services.[52] The question is a delicate one for a number of reasons. First, today's huge public debt effectively restricts possible fiscal decentralization, limiting not only the taxes to be transferred to lower levels but also the scope for the new functions to be assigned to them. The idea of "decentralizing" the national debt to the regions is impracticable as well as inequitable. It would hurt the chances for political and fiscal decentralization, aggravating regional disparities.[53]

[51] On the contrary, Buglione (1993) maintains that at least in the medium term such grants must continue to be the main source of revenue for local governments, because the enactment of substantial taxation authority at that level will not only be lengthy and complicated, with delicate implications for the national budget, but would also conflict with the need for financial equalization between the regions, which would have to be endowed with sufficient means to perform the functions reassigned to them.

[52] See Bird (1993), Helm and Smith (1987), Hughes (1987), King (1984) and Patsouratis (1990).

[53] For estimates, see Patrizi and Rossi (1994, p. 314, note 5). According to this study, if the debt were distributed in proportion to each region's share of Italy's GDP, the outcome would be the following: "33 percent of today's public debt, or about 600 trillion lire, would be assigned to the northwestern regions (Piedmont, Valle d'Aosta, Lombardy and Liguria), 21 percent (400 trillion lire) to the northeast (Trentino-Alto Adige, Venetia, Friuli-Venezia Giulia, Emilia-Romagna), 21 percent (another 400 trillion) to the central regions (Tuscany, Umbria, Marches, Latium), and 25 percent (500 trillion) to the southern regions (Abruzzo, Molise, Campania, Apulia, Basilicata, Calabria, Sicily and Sardinia). To appreciate the significance of these figures, let us recall that in 1991 about 72 percent of Italian households' government securities portfolio was held by residents in the north, 16 percent in the centre

Nor can one contemplate the hypothesis of a fiscally decentralized Italy in which as a practical matter the central government was left only the task of managing and servicing the existing public debt. Indeed, if recourse to borrowing by the local governments is ruled out, then other things being equal their present imbalances would be transferred to the central government, further increasing the total debt. In this case the perception of the central government as purely parasitic would be overwhelmingly strong, threatening the continued existence of the Italian state itself.

On the one hand, one cannot fail to approve the justified demands for more and more effective decentralization to enhance citizen participation in public affairs, make decisions more visible and heighten financial responsibility by tying benefits to costs. But on the other hand one must be practical concerning the real scope for such autonomy in the immediate future. Until Italy's finances are put back onto the path of stability, with a balanced central government budget, the space left over for decentralization will be cramped indeed. If such decentralization is carried out anyway, the tendency will have to be to decrease total expenditure net of interest payments, not increase it.

In addition, we must identify the taxes that can provide the practical, solid foundations for a decentralized fiscal system. Italy's most important sources of revenue today are unhappily ill-suited to more pronounced local autonomy. No viable solution is offered by the income tax, not to mention withholding tax on interest income and excise taxes, given the constraints on the central government's finances and the sort of tax competition that their decentralization would trigger.[54] Local governments would have some sources of revenue (taxes on consumption, real estate taxes, taxes on refuse, licensing fees for the use of public terrain, etc.), but these would add little to the resources already at their disposal.

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and 12 percent in the south, including the islands. Moreover, the bulk of the government securities held by financial institutions must also be attributed almost entirely to the northern regions".

[54] What is more, the geographical redistribution of these levies would be powerfully distorted by administrative factors that would alter their function, apart from the intuitively counterproductive effects of distributing them on a regional basis (Patrizi and Rossi 1994, p. 304). The institution of independent taxing powers for the regions and other local governments would inevitably create disparities of treatment, not only as regards the taxes selected by each region and their implementation but also because of differences in the quality of monitoring and enforcement. Collection costs would be greatly increased, as each government would have to strengthen its revenue services (Buglione 1993, p. 2).

The issue, in short, is clear-cut. Either Italy finds the courage and the political will to reform the tax system – introducing authentic new local taxes (principally consumption taxes or retail sales taxes on the U.S. model, as suggested in Marè and Sarcinelli 1991), going over to the principle of benefit, and revising real estate and property taxes – or else fiscal federalism will never be more than a continually frustrated aspiration. And even if structural reform is undertaken, we must not underestimate the revenue losses that may be incurred during the transition to the new system; given the present enormous debt, these could prove unsustainable.

In conclusion, fiscal decentralization is not an adventure to be embarked upon regardless of cost. What it can and must be, rather, is an opportunity to simplify and rationalize the tax system, to make the provision of public services more efficient through greater citizen participation, among other things, and to strengthen democracy by enhancing the diversity of representative institutions. If fiscal decentralization is devised in such a way as to avoid aggravating social tensions at the local level, the existence or stability of the national government will not be threatened but reinforced.

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