

FISCAL FEDERALISM AND FISCAL DECENTRALIZATION IN AN ENLARGED EUROPEAN UNION

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Fiscal competition and tax harmonisation are two of the main current issues in the enlarged European Union. Achieving these goals and thus improving the EU economic governance is partially dependent by the way we understand and practice the so-called fiscal federalism and fiscal decentralization at the national and European level. Our paper aims to emphasize the similitude and differences between fiscal federalism and fiscal decentralization and revealing the way in which the functioning of the European Union is affected by them.

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The Legal Content of Fiscal Federalism and Fiscal Decentralization

The matter of fiscal federalism is not new, but its complexity and its special implications upon the functionality of public budgetary systems, and implicitly upon the mobilization and the judicious use of public financial resources, determine its being brought to attention in many contemporary works regarding the European integration process. As concept, fiscal federalism is often related to fiscal decentralization and sometimes even considered similar to it, although the two notions appear as different due to their own formulation. Thus, decentralization would mean, as its name itself suggests, the fact that power naturally belongs to the centre, which decides to transfer it to the lower levels, for reasons related to a better management of local interests or at least more adequate to the preferences of the members of the local community. On the other hand, fiscal federalism would imply the pre-existence of competence sharing in what concerns the mobilization of public revenue, (fiscal) decentralization not being necessary any longer, at least at first sight. In other words, the federal system of power structuring is intrinsically based on a larger decentralization than the unitary state system of organization. Such a view is false, because practice shows that there are very decentralized unitary states (e.g. Denmark, The Netherlands), as well as very centralized federal states (Austria). Because decentralization (fiscal, implicitly) is inherently possible and present, just as centralization, in any state community, the problem that arises is to differentiate it from federalism (implicitly fiscal). In what concerns us, we believe that the main differentiating element of the two notions is the legal and not the economic content. Thus, the federal organization of certain states is, as the case may be, either the product of the tradition of state organization or the result of applying certain requirements for making the management of public sector problems more efficient. Federalism, as a (constitutional) state organization method, supposes an allocation in essence of (public) political power by delimiting it on several levels, ensuring its constitutional and decisional sanction for each of the entities forming the state, by means of their own Constitution and their own decisional bodies, even in what concerns the ability to legislate (at the level of each federal state). One may notice, in these conditions, that, within the federal type of state organization, it becomes essential the fact that the constitutive states are independent, as the decision-making autonomy of the main government levels (federal and federated) is sanctioned by means of the fundamental document, simultaneously and differently allotted both at the central level and at the level of the constitutive states of the federation and protected from any possible decision-making conflicts by

means of the bicameral structure of the Parliaments. Actually, while federalism is a constitutional way of organizing public power, which affects both the legislative power and the executive and judicial ones, decentralization is a (main) way of exercising power, which only applies to the executive power.

The Economic Content of Fiscal Federalism and Fiscal Decentralization

However, in what concerns the economic approach, what is essential for the federal organization of public power (the presence of a separate Constitution at the level of each federated state) loses its significance, the important thing being the fact that each government level has its own competence in managing and providing public services, which is essentially something in common with decentralization, as a principle of exercising the executive power. In these conditions, fiscal federalism is defined as a set of principles which stand at the basis of delimiting revenue sources and budget expenditures between the central level and the inferior government levels, sometimes even without taking into account the type of state organization. This set of principles, which may be applied to the relationships between the components of the public budget system on the revenue side, whatever the form of organization of public power from the point of view of state structure, leads to the practical implementation of what we call “fiscal decentralization”, manifesting, in practice, in the form of a general (normative) framework that this requirement takes. It is this framework, through its concrete implementation in the European states, which individually start to promote it because of the necessity to satisfy certain “national” internal requirements, that may determine, in the context of the European integration process, a series of undesirable dysfunctions (distorted competition, fiscal evasion, limited fiscal harmonization, etc.). These potential negative effects are first a result of the fact that the principles under discussion are applicable or applied differently in each state, with differences noted especially between the unitary and the federal states, as they are not able to represent a “universal recipe”. Although “universalization” of the set of principles considered to be the content of fiscal federalism (in the sense of them being universally recognized) may be found in the related literature and in practice, each of these principles involves a certain degree of relativity, in the sense that it has to be connected to the requirements and the actual reality in each state. Moreover, one and the same principle may be interpreted and applied more or less nuanced, thus leading to a particular way of promoting fiscal decentralization. For example, the subsidiarity principle applied to the mobilization of budget revenues or the principle of assuring a certain level of local autonomy involve judgements that are subjective in their nature, regarding the extent and the beneficial effects of allowing competences to the local government level, thus leading to different manners of applying subsidiarity and to different interpretations of the degree of local autonomy. On the other hand, the theoretical foundations of fiscal federalism and its applicability are still submitted to observations and reconsiderations, sometimes even by those who put them forward (Richard Musgrave, Charles M. Tiebout, W.E. Oates), “a second generation” of fiscal federalism being invoked.

Fiscal Federalism at National and European Level

Beyond the conceptual differences that we presented, the economic content of the two notions is relatively close, referring to delineating the competences of central and local authorities related to their “rights” regarding the mobilization of public revenues and their use, and, according to some, “the big challenge is to ensure a transparent financing system for sub-national administrations”⁴⁰⁶. We notice that, according to such a view, what is considered to be essential to fiscal federalism is the relationship between public authorities on different levels, which

⁴⁰⁶ Moşteanu, T., Iacob, M., *Fiscal Federalism*, Theoretical and Applied Economics, 2007, vol. 11, p. 21, <http://econpapers.repec.org/>

consists in financially involving the one at the superior level in order to support, if necessary, the authorities at the inferior levels. From this point of view, an analogy may be made between “internal” and “international” fiscal federalism, the latter concerning the relationship between national and supranational authorities or international organizations (in international finances). Judged by appearances, such a manner of practising financial relations would not be related to fiscal federalism, because the latter has a legal (constitutional) basis which lends it a regular and compulsory character, while the involvement of the international organizations has an optional, incidental character, involving both the request from the national authorities and the acceptance of the international organization. However, we notice that phenomena such as global warming or world security, which concern all nations, not only some of them, objectively determine a joint, even unitary, approach to solving such needs, by means of common supranational institutions or organizations. This phenomenon, related to such mutations as globalization or the European integration, gives rise to the need to establish separate revenue sources for supranational authorities, able to ensure the resolution of the problems in their competence, which sets the basis for building a system typical for “fiscal federalism”. In the specific context of the European Union organization and functioning, some claim that the establishment of a European tax system is just a matter of time⁴⁰⁷. A convincing example in this respect is considered to be the action mechanism specific to the European Union, in which the common institutions manage problems for the benefit of all Member-States, thus taking over financial resources to its own budget from the resources of the states involved, in the context in which many of the tax-related decisions are harmonized by means of normative documents issued at this level. Although the prevailing view is that total relinquishment of fiscal authority is not something that can be taken into consideration, the decisions regarding taxation (especially indirect) are at least partially in the competence of the Union, which is exactly what forms the core of fiscal federalism. The existence of a system in which the competences regarding the management of certain problems are attributed to national and European-level authorities on a differentiated or complementary basis, combined with the presence of a taxation and intergovernmental grant framework can only be qualified as fiscal federalism. However, in the related literature there are also some studies that dispute the presence and the applicability of fiscal federalism in the European Union, either in the larger context of multilevel governance finances⁴⁰⁸, or considering that it exceeds the conventional framework of fiscal federalism by being exceedingly decentralized⁴⁰⁹. The argument they put forward is that, in attributing the functions to the different government levels (in this case, to national and European-level authorities), the reasons specific to fiscal federalism (such as macroeconomic stabilization, which central authorities must have in view) are subject to a different interpretation, in the sense that only the monetary policy may be decided at the supranational level and not the fiscal policy. The argument may be considered valid, but it must be approached in a cautious manner. It must be noticed that the authors in question themselves mention as a premise for the analysis that fiscal federalism is not a set of universally applicable rules, but rather a set of benchmarks to follow (on a differentiated basis, o.n.) in delimiting the competences related to the management, taxation and spending of the financial resources thus mobilized. As a result, we believe that the analogy between “internal” and “international” fiscal federalism subsists, with the note that in the latter case the implementation method is different. The different manner of promoting fiscal federalism at the supranational level has an explanation which is as simple as it is convincing: as long as the relationships of public power are differently

⁴⁰⁷ Moşteanu, T., Iacob, M., *Fiscal Federalism*, Theoretical and Applied Economics, 2007, vol. 11, p. 21, <http://econpapers.repec.org/>.

⁴⁰⁸ Oates, W., *Fiscal Federalism and European Union: Some Reflections*, Societa Italiana di Economia Pubblica, 2002, <http://www.unipv.it/websiep/wp/132.pdf>, p. 2

⁴⁰⁹ Eichgreen, B., *Saving Europe's Automatic Stabilisers*, in Baimbridge, M., ş.a., *The Impact of the Euro - Debating Britain's Future*, Macmillan, London, 2000.

legally sanctioned at the internal level and at the level of international cooperation, the attribution of the competences of taxation, spending or management of public matters outlined based on these relationships will be, in its turn, different. It is without doubt that the attribution of some competences, such as macroeconomic stabilization or the redistribution of revenues meant to prevent poverty or to protect those with low income, to the supranational (European) level may have weaker effects than the management of these aspects by the national government levels, but this does not affect the core of fiscal federalism. Moreover, the rules applicable to fiscal federalism promote subsidiarity, which requires that a certain task be attributed to the government level closest to the place (level) where the problem has arisen, on condition that the management of the problem in question cannot be better dealt with at a superior level (in order to avoid distortions). In other words, if the distinctiveness of the relations between the European Union and its Member-States requires that certain aspects such as those mentioned above be managed by the national authorities, we are talking about fiscal federalism.

In the context of the European integration process, taking into account the characteristics of the political and administrative organization of this entity compared with the known composite forms of state or with the unitary states, until not long ago, the prevailing view was that, at least from the point of view of budgetary revenues (in effect, of taxation), the transfer of the decision-making process in this respect to the Union level would be a forbidden and inadequate assignment of “sovereignty”, considering that as long as taxes are the main support (from a financial point of view) of the sovereign manifestation of states, no member-nation would be willing to give up such rights. However, it can be noted that, if the presence into a functional association in the genre of the European Union is desired, whatever (legal, constitutional) qualification we may confer to it as a form of organization, it is first necessary that all the parties involved take on a relative “loss” from the point of view of decision-making power, because the minimum consensus necessary to any such association in order for it to function in good conditions may not be otherwise gained. In our case, it can be noted that generous objectives such as ensuring free circulation, undistorted competition, a high living standard, at similar levels in the member countries, are accepted on a large scale, but it is not always admitted that reaching them involves a joint action of the Member-States, conceived for reasons of coherence and unity of action at the supranational level, of the Union. In other words, just as the Member-States, especially the unitary states, ensure their functionality and compatibility between the different interest and government levels by means of a minimum degree of centralization (reduced by decentralization, local autonomy, subsidiarity), the European Union is able to efficiently reach its shared objectives in a similar way. This opinion is also confirmed in practice (at least partially in what concerns the Member-States), due to the use of the single currency, and the unity of the monetary policy designed and promoted by the European Central Bank⁴¹⁰.

Taking into account the previously set forth arguments, we believe that the opinion expressed by the majority of those interested in the matters related to the working of the European Union in the sense that sovereignty cannot be relinquished, especially at the fiscal level, must be reconsidered. A first argument is that the decision-making right in certain areas at the European level lacks efficiency as long as there aren't any efficient implementation instruments. An eloquent example in this regard may be the evolution of the last years in what concerns the budget deficit, in some of the Member-States of the European Union, ironically and almost paradoxically exactly those considered as the initiators of the rule regarding the 3% limit on the budget deficit. States such as France, Italy or Germany are recording budget deficits that exceed this limit, at the same time with a breach of the rule regarding the maximum indebtedness level of 60% of the GDP (in the case of Italy, over 100% in 2007), which, according to the rules, would lead to these countries

⁴¹⁰ Oates, W., *Fiscal competition and European Union: contrasting perspectives*, Regional Science and Urban Economics, no. 31, 2001, pp. 133-45.

facing financial sanctions. Faced with such a situation, the countries in question proposed as a method of resolution, without asking for the rule to be removed, that the causes of the deficit be separately analyzed for each state. For example, Germany invoked the use of 4% of the GDP for the necessities of reunification, at the same time proposing that the contributions to the Community budget may not be taken into consideration, and President Chirac put forward the productive character of certain expenditures which would justify their being taken out of the calculation when determining the budget deficit (“the research and development expenditures of today ... are the riches of tomorrow”). In these conditions, it can be noted that the lack of an efficient instrument of constraining the actions of the national authorities may give rise to dysfunctions at the Union level, being necessary to attribute extended competences to this level. In the case of direct taxation of income, although we agree with the idea that macroeconomic stabilization for 27 countries simultaneously at the Union level would not necessarily be more efficient than the separate action, at the national level, we have to remark that, in the present conditions, there is a fiscal competition which may lead to distortions in allocating resources. The single rate implemented by some European states, without any restriction, is generating differences that may have negative effects. Although it is not entirely necessary that the European Union implement the so-called „European taxes”, as there are problems mainly related to recording and evaluating the taxable matter, determining the tax value, levying or keeping track of and collecting tax claims, it is obviously necessary to harmonize taxation bases or direct tax rates. Two mentions must be made: harmonizing does not automatically mean “standardizing” (in the sense of setting the same taxation rate at the level of all the states, but only setting ranges between which these rates may vary), and harmonizing taxation rates without harmonizing taxation bases (for example, the unitary setting of the elements that stand at the basis of calculating the taxable profit) would strip the entire action of its efficiency. This statement has its origin in ascertaining that economic and budgetary systems are not based, in their functionality, solely on related decisions of a subjective, administrative nature, but have at their basis the so-called system of incorporated stabilizers, which first includes the taxes applied by the Member-States. Their reaction to the economic context may be a beneficial one as long as, in their position, the reasons they started from took into consideration the future implications on other Member-States (taking into account, first, the action of economic operators in the context of free circulation). Moreover, we believe that the indispensability of establishing a system such as fiscal federalism within the European Union derives from accepted economical reasons, knowing that the fiscal policy (in its narrow meaning, of tax policy) and the monetary policy must be considered related parts of the general, economic and social policy of a state entity; their positive effect can only be ensured as long as the measures devised and promoted for each of the two areas are harmonized and lead to (or support) similar results and are not opposed, annihilating each other’s desired effects. In this respect, the free practice, by the Member-States, in the absence of a constraint which is possible under a fiscal federalism type of organization, of expansionist fiscal policies may lead to inflationist effects, thus harming the effectiveness of targeting inflation through the European monetary policy.

From another perspective, that of understanding taxes (beside public expenditures) as a means of achieving solidarity between the members of the entity in question, we notice that in what concerns the European Union, tax is not yet perceived as such an instrument, interstate solidarity being rather limited, still⁴¹¹. As a matter of fact, in most cases, redistribution of resources within the European Union is discussed only from the perspective of the expenditures supported by the Union budget, without the necessary reference to related resources and the implications of their collection based on the product generated in the Member-States, the matter

⁴¹¹ Collignon, S., *The European Republic – Reflections on the Political Economy of a Future Constitution*, London, 2003, pp. 104-105

of the resources of the Union budget being the object of separate discussions. The positions expressed in this regard are often contradictory: on the one hand, they say that the Union does not have any competences related to direct taxation (especially of income); on the other hand, they require that financial resources be attributed through the system of supranational transfers. Such opinions are also favoured by the fact that, in the context of the absence of disruptive phenomena (at least until now, when the financial crisis is settling in more and more), which would require that more attention be paid to (macro)economic adjustment and stabilization, the European Union as well as the Member-States have channelled their attention primarily to the aspect of the redistribution of resources (for example, by means of the structural funds, which have economic and social cohesion as a purpose).

Conclusions

In conclusion, we think that fiscal federalism cannot be considered in any way a phenomenon incompatible with the European organization or an inhibiting factor for it. It must necessarily be designed and promoted at this level, without it being understood that it should be applied in its conventional formula, which is not allowed by the characteristic itself of the political and administrative organization of the European Union. Centralization becomes an absolutely necessary trend in the Union, but it must be carefully applied and must not be in any way interpreted as a possibility or a potential danger of “levelling” the Member-States of the Union, by excessively reducing or erasing national differences. The management of asymmetries in the economic and social development at the Union level, as well as of the transfer of undesirable effects from some states to others in the context of free circulation (especially of workers and capitals), requires, in an absolutely rational and necessary manner, that the European Union takes on extended competences and that the Member-States recognize to a larger extent the importance of interstate solidarity and joint action.

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