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The Centralization-Decentralization Issue

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Abstract

The make-up of the EU institutions, and their evolution, should explicitly be based on widely accepted federalism principles. This paper applies federalism principles to a few crucial questions, mainly fiscal policy, fiscal discipline and structural reforms, using where possible lessons from existing federations. After introducing the topic, Section 2 briefly reviews the key message from the fiscal federalism literature. The following sections use these principles to examine a number of areas where centralization may be insufficient or excessive in the EU. Section 3 looks at public spending, both in the aggregate and my main functions. Taxes are examined in Section 4. The next section looks at the issue of fiscal discipline, a weak spot of the Eurozone. The allocation of policy competences, a key characteristic of the UE, is the object of Section 6. The last section concludes.

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Keywords: fiscal federalism, centralization-decentralization, fiscal policy, fiscal discipline, allocation of policy competences, EMU design.

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1. Introduction

> *"The problems of monetary union à la Maastricht, in other words, cast doubt on the feasibility (and perhaps the desirability) of harmonization of fiscal policies and the social and distributional objectives that they embody."*
> *Wildasin (1996)*

European integration has reached a low point. Two major crises since 2007 – first the global financial crisis, then the sovereign debt crisis – have exposed deep governance problems and construction flaws in the Eurozone. Unprecedented economic hardship has dented citizens' support for European integration to the point where euroskepticism is a popular vote-getter in virtually all EU countries. As always, economic hardship breeds political populism, but this time populism takes the form of anti-Europe agitation. The previously-thought impossibility that countries could leave the EU is becoming a plausible scenario. European integration is no longer a one-way street.

A common response, popular amongst European and national elites, is that now is the time to go to the next integration step.[1] Important changes decided since 2008 go in this direction: the Treaty on Stability, Coordination and Governance (TSCG) and the Banking Union both amount to further transfer of sovereignty away from member states. This is in line with the Jean-Monnet method, which foresees quantum integration steps in response to crises. It is a natural consequence of the treaty-sanctioned quest for "an ever-closer union".

Yet, another long-identified issue is the "democratic deficit". The decision structure of the EU confers considerable policy-making powers to bureaucratic institutions, that is institutions whose power does not come from elections, such as the European Commission[2] or the European Central Bank. Even the Council, which brings together elected leaders, can be seen as a bureaucratic power because the leaders make collective decisions which go beyond the national mandates that legitimize their authority. For decades, we have paid lip service to the democratic deficit, but it now seems that the bird has come back to the nest to roost. One response has been to grant the European Parliament co-decision powers, but this institution operates more as a second chamber than like a real parliament elected on the basis of a European-wide debate on key issues faced by the EU. The creation of European political parties does not conceal the fact that MEP are elected as members of national parties, which typically campaign on national issues. Even when they advance truly European proposals, these ideas can differ considerably from one country to another, and they are even sometimes incompatible with one another. Paradoxically, co-decision may end up muddling policy decisions and deepen the democratic deficit.

The issues at stake fall in the much-studied area of fiscal federalism. Of course the European Union is not a

[1] A telling example is Juncker et al. (2015).

[2] In 2014, the President of the Commission was chosen as the leader from the party that won most votes in the elections to the Parliament. Yet, his appointment was, and remains a decision of the European Council.

federation, even though it has some federal features. Member countries have given up a number of previously sovereign functions, mostly in the areas linked to the Single Market, including trade and competition. In addition, a number of countries share a common currency and have given up monetary policy sovereignty; indeed, the Eurosystem is a federal arrangement. It would be desirable, therefore, that fiscal federalism principles underpin the EU architecture. Symptomatically, however, the word “federal” is considered as politically incorrect so that fiscal federalism are rarely invoked in policy discussions. For instance, the recent “Five-President Report” (Juncker et al., 2015), a catalogue of proposals to deal with the EU’s malaise, does not mention at all fiscal federalism principles. Could it be, though, that these principles implicitly shape the EU architecture, either through spontaneous re-discovery or through silent application? This is the question addressed in the present paper. To that effect, it applies federalism principles to a few crucial questions, mainly fiscal policy, fiscal discipline and structural reforms, using where possible lessons from existing federations.

The next section briefly reviews the key message from the fiscal federalism literature. The following sections use these principles to examine a number of areas where centralization may be insufficient or excessive in the EU. Section 3 looks at public spending, both in the aggregate and my main functions. Taxes are examined in Section 4. The following section looks at the issue of fiscal discipline, a critically weak spot of the Eurozone. The allocation of policy competencies, a key characteristic of the UE, is the object of Section 6. The last section concludes.

2. Fiscal Federalism Principles: A Simple Summary

Dating back to Oates (1972), a large theoretical and empirical literature examines how to assign spending and taxation powers in a federal system (for a survey, see Wildasin, 1996). The literature also includes the issue of fiscal discipline, as discussed in von Hagen and Wyplosz (2008). The driving elements of this literature are the presence of externalities and of returns to scale, which favor the federal level, and information asymmetries as well as heterogeneous preferences, which favor sub-federal levels. This immediately alerts us to the fact that any centralization or decentralization choice should result from the balancing of various trade-offs.

The literature has been further refined to take into account the existence of economic and political failures. The existence of such failures means that each choice of the degree of centralization is inevitably in the nature of a second best (in fact a *n*th best) and depends on both local specific economic conditions and governance aspects. Tommasi and Weinschelbaum (2007) focus on political failures. Governance issues at both the central and sub-central levels lead to a preference for decentralization, largely because it introduces an element of (political) competition meant to provide incentives to improve local dysfuntions. This result comes on top of the usual argument, initially developed by Olson (1971), that smaller constituencies are more homogeneous and, mostly, provide for better control of their politicians than larger ones where voter power is diluted.

The important message is that there is no universally best way of building a federal system. However, this does not mean that "anything goes". Federal institutions must be compatible with the theory's general principles complemented by a careful consideration of specific local and historical circumstances.

European integration is a unique historical experiment inasmuch as it does not explicitly aim at forging a federal state, only at an "ever closer union". The implication is that there are no simple, off-the-shelf, prescriptions coming from an already ambiguous literature. Because a large number of cases imply finely balanced trade-offs, a decision rule is needed. This is the role of the subsidiarity principle. Simply stated, it holds that decision power should be located at the decentralized level unless there is a strong case for centralization. Put differently, decentralization is the default option. However, as written into the Treaty on the Functioning of the European Union (TFEU), Art. 5(3) provides a less clear-cut definition. It recognizes the presence of trade-offs and does not really sets decentralization as the default option.[3] The Court of Justice of the European Union, which has the last word on the matter, has generally taken a pro-centralization view of ambiguous cases.

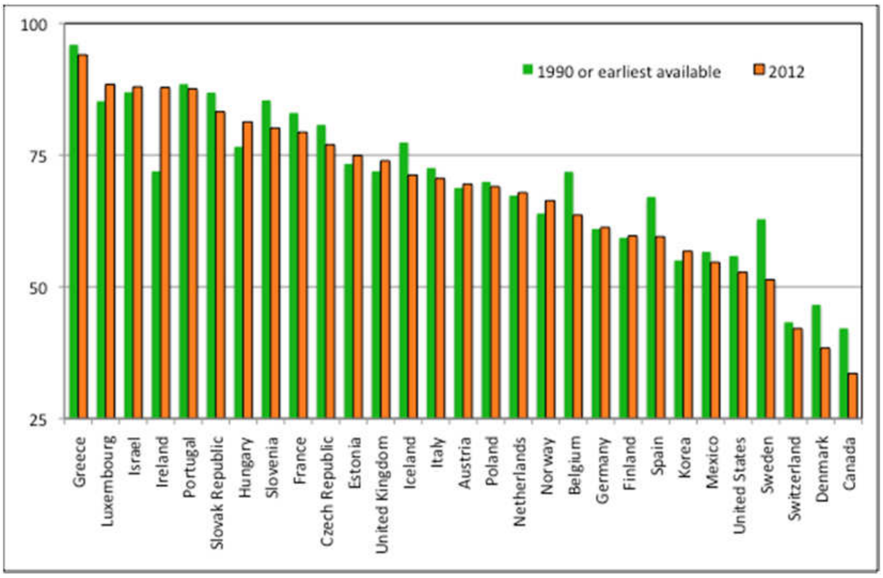
[3] Art. 5(3) reads as follows: "Under the principle of subsidiarity, in areas which do not fall within its exclusive competence, the Union shall act only if and in so far as the objectives of the proposed action cannot be sufficiently achieved by the Member States, either at central level or at regional and local level, but can rather, by reason of the scale or effects of the proposed action, be better achieved at Union level."

3. Public Spending in the EU

3.1. AGGREGATE SPENDING

With a very small Commission budget, the EU does not have the main attributes of a federal state. The Commission does not levy its resources; instead it depends on member states to decide how much to transfer from their won tax revenues. As Figure 1 shows, with expenditures amounting to about 2% of total public expenditures (general governments and the Commission), the EU is not anywhere near other federal states.

Figure 1 Size of central governments (% of total public expenditures)



Source: Fiscal decentralization database, OECD.

Less than half of the Commission's budget is used for collective spending, mostly the administrative costs of the EU institutions. As noted in Section 4.2, the remaining is used for transfers, not for direct spending. The main exception is scientific research, which is administered and funded by the Commission, and represents about 10% of total spending.

There is a well-understood explanation for the situation. Democracy was born when elected bodies were given the final say on taxation and public spending. European citizens still consider fiscal policy as a key attribute of the State. As long as they consider that the State is fundamentally national, fiscal policy will remain wedded to national sovereignty.

From a fiscal federalism perspective, the central budget is remarkably small. It is as if there are almost no policies that are characterized by important externalities and/or returns to scale. Yet, it is not difficult to list a few policies that would qualify: defense, including border protection, diplomacy, or intelligence. These policy areas are indeed mostly federal in federal states such as the US, Canada, Switzerland or Australia, along with health and social policies. Clearly, defense and diplomacy are seen universally as regal functions and there is little prospect for the Commission to take over beyond the rump diplomatic service already in place. Health and social policies are taken up in the next section. The conclusion is that, at this stage of limited political integration, the EU's center spending power is unlikely to grow.

3.2. POLICY ALLOCATION

Much of the fiscal federalism literature is devoted to determining the level of government at which each spending catgeory is better located. As noted earlier, this involves balancing various criteria: externalities and increasing returns vs. information asymmetries; additional considerations include possible policy failures (including capture by interest groups) at different levels of governments.

Table 1 shows how public functions are allocated in a number of European countries. The diversity of arrangements stands out, showing how the various trade-offs are dealt with. More surprisingly, perhaps, the distinction between federal and unitary states does not really help interpreting actual choices. Education is the only unambiguous spending category that is clearly decentralized in federal systems, and even in many unitary systems. Housing and public order (which presumably includes police and justice) are often decentralized. These categories all involve strong local preferences, information asymmetries and relatively limited externalities. Income disparities often lead to transfers, either vertical or horizontal.

In the EU, all the categories listed in Table 1 are fully decentralized to the national level, often to the subcentral level. Given the diversity of practices in member countries, there is little scope for the centralization of any of these functions to the EU level. The ambiguity of theoretical prescriptions, the diversity of preferences and the subsidiarity principle, imply that most public spending is bound to remain highly decentralized.

Table 1 Share of subcentral government spending (%of total government spending)

	Education	Health	Social Security and Welfare	Housing and Local Amen-ities	Public Order and Safety	Econ'c Affairs and Services	All Func-tions
FEDERAL COUNTRIES							
Germany (1996)	96	28	79	93	92	64	38
Switzerland (1999)	90	31	23	85	93	37	47
Austria (1998)	72	48	9	25	3	n.a.	31
Spain (1997)	71	31	6	93	41	60	32
UNITARY COUNTRIES							
Denmark (2000)	46	95	55	33	13	35	46
Norway (1998)	63	77	19	87	17	17	34
France (1993)	37	2	9	82	28	18	17
Netherlands (1997)	33	5	14	79	25	26	22
UK (1998)	67	0	20	41	52	29	22
Ireland (1997)	22	48	6	70	100	70	25

Source: Darby et al. (2003)

Still, welfare spending has recently been identified as a candidate for some degree of EU centralization in a number of proposals. For instance, Claeys et al. (2014), have suggested that the EU should adopt a common system of partially centralized unemployment benefits, as initially foreseen in the MacDougall Report (1977). This proposal is based on the need for countercyclical horizontal transfers, which act as mutual insurance. Mutual insurance is justified by returns to scale and the existence of an externalities among highly integrated regions (and countries in the EU). Indeed, most federal states rely on the central government for this task. Currently, the EU lacks a central budget that could act as a counter-cyclical instrument. The externality is most clearly felt in the Eurozone where individual member countries have abandoned the monetary policy tool. Their only remaining counter-cyclical instrument is fiscal policy, which is restrained by the Stability and Growth Pact (SGP). Furthermore, the Sovereign Debt crisis has shown the deleterious effect of the existing arrangement.

The need for some collective countercyclical policy is indeed an additional argument in favor of centralization in the Eurozone. The usual counter-arguments emphasize the diversity of unemployment benefits in place. This is why the proposals typically only include a minimum of Eurozone-wide benefits, to be topped up in each country according to existing arrangements. Another aspect concerns eligibility criteria, which also vary considerably. The solution would be to adopt the minimum common eligibility criterion, complemented as needed at the national level.

However, such transfers raise a moral hazard issue. Given wide differences in structural unemployment, care must be taken to avoid permanent transfers from low to high unemployment countries. Differences in structural unemployment rates reflect deep local preferences, often the result of policy failures, which are even more unlikely to be erased if the failures are rewarded through transfers. The natural solution is to focus on deviations of actual from structural unemployment. This is a technically complex approach, however, open to manipulations and controversies. Indeed, part of the reason for these divergences lies in unemployment benefits eligibility criteria, a deeply political issue.

An alternative solution, partial sharing of unemployment benefits, may be politically appealing, but it combines both moral hazard and weaker counter-cyclical policies at the central Eurozone level. The more limited the scheme, the less worrisome is the moral hazard issue but the less effective is the scheme. The trade-off is obvious, and challenging.

At this stage, it is worthwhile to specify what failures are to be treated and which policy responses are justified. Cycles are largely driven by price and wage rigidities, hence the unassailable need for counter-cyclical policies. If these rigidities vary from country to country, centralization is not directly justified. However, in addition to the existence of externalities and returns to scale, noted above, the case for centralization can invoke the idea that limits on the use of national fiscal policies are justified by the need to establish fiscal discipline but, as discussed in Section 5, the proper response is not a centralized solution like the SGP. A further reason for limiting national fiscal policies is the current existence of large public debts, which limit the policy space in a number of countries. Section 5 argues that a temporary situation – large debts – should not shape permanent institutions.[4] Once these two policy failures – improper fiscal discipline framework and large inherited public debts - are taken care of, national governments will be able to fully recover the ability to conduct counter-cyclical fiscal policies, thus avoiding the highly uncomfortable choice of a partially centralized unemployment benefits system.

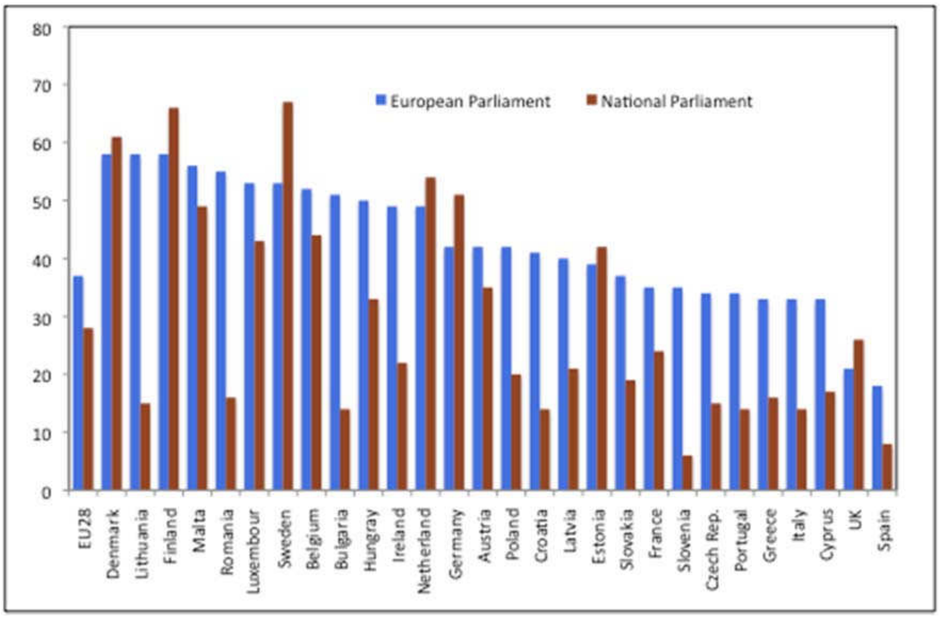
[4] Furthermore, public debt restructuring is possible and, indeed, necessary, as argued in Pâris and Wyplosz (2014).

4. Taxation and direct transfers

4.1. TAXATION

The principle of "no taxation without representation" sets a high hurdle for centralization. Until citizens recognize the European Parliament as representing their interests, there is little scope for EU taxation. How far are we? For the EU as a whole, the latest *Eurobarometer* survey reports that 37% of respondents trust the European Parliament, a low number, but trust in national parliaments is even lower at 28%. The situation varies considerably across EU member countries, as Figure 2 shows. The correlation between trust in the national and European Parliaments (0.58) suggests that citizens apply domestic lenses to look at European politics.[5] Even so, its better performance probably does not provide the EU Parliament with sufficient support to claim a transfer of some taxing power. It stands to see its legitimacy further eroded the minute it acquires and exercises this power.[6]

Figure 2 Trust in European and National Parliaments (%)



Source: Eurobarometer 81, European Commission, Spring 2014.

4.2. TRANSFERS: A PROPOSAL

Fiscal federalism principles argue in favor of matching taxation and spending, possibly along with transfers intentionally designed to be redistributive. The reason is that one of the arguments in favor of decentralization is proximity to citizens and easier internalization of externalities, including sharing the tax burden to finance local public goods. Any imbalance between spending and revenues, which requires transfers across the federal units,

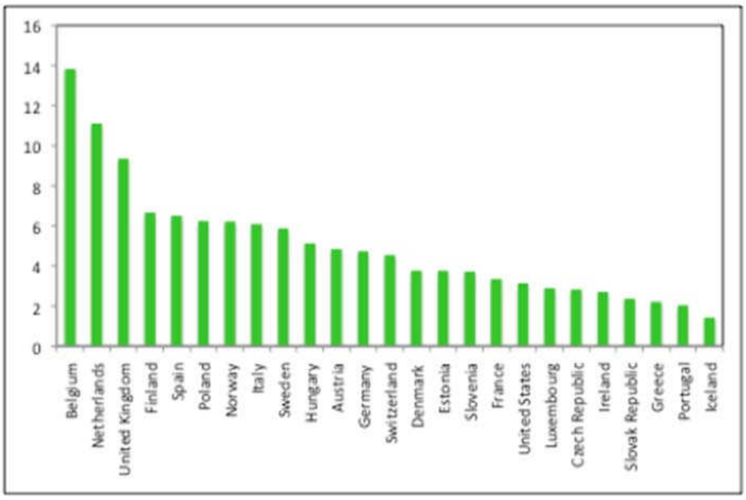
[5] Not surprisingly, perhaps, trust is lowest in the Eurozone countries hit by the crisis.

[6] It matters that trust in national parliaments is higher in the Northern countries, including Germany. Arguably, the opposite often occurs in politically troubled countries, including the more recent democracies of Central and Eastern Europe.

breaks this logic. Such transfers are also often controversial and prone to pork barrel politics.

Here again, the EU lies at the extreme end of decentralization. Vertical transfers, from the EU to national budgets represent about 0.5% of EU GDP. There are virtually no horizontal transfers, from state to state. As Figure 3 shows, in most OECD countries transfers from the central governments are typically small, but not negligible. The EU vertical transfers are mostly limited to the Cohesion Policy and the Common Agricultural Policy. These policies are explicitly redistributive, and both are controversial.[7] Controversy is quite natural because redistribution is a zero-sum game and because it is unlikely to enhance growth, one of the official objectives of the policy.

Figure 3 Gross transfers from central government (% of GDP)



Source: Fiscal decentralization database, OECD.

Many reforms of the Cohesion Policy and of the Common Agricultural Policy have been attempted over the years, resulting in changes that have been limited and disappointing to most countries. This is largely the result of a zero-sum game combined with pork barrel politics. Sadly, as the main expenditures of the EU, these policies have become a negative symbol. Because the costs and the benefits are unevenly balanced across countries, doing away with these policies is politically impossible. A reform, therefore, would have to recognize that those countries that tend to loose are properly compensated.

A solution is possible, however. It would shrink the program budgets to their net balances, country by country, thereby freezing existing transfers. Ideally, these transfers would be subject to a sunset clause on a long enough horizon to be acceptable by the governments currently in place. Governments that are currently net recipients would direct the transfers to current beneficiaries, possibly topping up these amounts to protect, fully or partly, the beneficiaries. Governments that are net contributors could redistribute the savings through other spending or tax reductions. This proposal has four interesting features.

[7] A small literature has attempted to detect the effects of the Cohesion Policy. The results indicate no or a small effect. For a review, see Hagen and Mohl (2009). Baldwin and Wyplosz (2015) discuss the role of politics.

First, it decentralizes the associated subsidies to the national level, where taxpayers are better able to judge the merits of these subsidies. In addition, decentralization breaks the confusion between subsidizing specific activities and inter-country transfers. The logic behind supporting farmers is distinct from the logic behind transfers from richer to poorer countries, an issue that successive reforms have failed to deal with effectively.

Second, it would remove a perennial irritant when the EU budget is discussed. The stakes of pork barrel politics would be lessened.

Third, it would mechanical reduce sizably the Commission's budget. This would be an opportunity to thoroughly rethink the resources and functions of the Commission, which never really happened since the Treaty of Rome. If it were decided to keep the resources about unchanged, this would be a great opportunity to re-allocate them towards policies that are explicitly justified on the ground of fiscal federalism principles. As noted above, defense, scientific research and networks could qualify, as they are subject to important returns to scale.

Fourth, sunset clauses are an appealing way to deal with the legacy of existing arrangements, which were and are poorly justified, as noted in Tanzi and Schuknecht (1996) and Wyplosz (2006). This would create a useful precedent.

4.3. TAX EVASION

A by-product of globalization is global "tax optimization". The existence of the Single Market obviously makes tax evasion even more attractive. Potential beneficiaries are firms that operate in several countries; they can use internal prices to locate profits where taxation is lowest. More generally, corporations can use a host of features of the Single Market to reduce taxes. Consumers too can arbitrage tax exposures through simple border or internet shopping, but also through the right to establish wherever they want. The very existence of the EU is an externality that leads to (mostly implicit) tax competition.

There is nothing new as federal states face the same situation, in fact a more complicated one as there is also vertical tax competition. The recommended solution, to associate taxes and public goods and services, is de facto implemented in the EU as nearly all taxes finance public goods and services delivered by member countries, in addition to transfers. Transfers, however, are more troublesome. Since they represent about half of public outlays in most EU countries, tax competition is a difficult issue. The solution cannot be to avoid taxing mobile sources. This has led to much soul searching, still under way.

In addition to an agreement on VAT ceiling and floor, this has led to calls for tax harmonization. Taking to its logical end, this externality would require a common tax structure throughout the EU. Against the externality argument, there is a massive local preference argument. Taxation is deeply redistributive, therefore profoundly political. National tax structures reflect both national preferences and histories. They represent a fragile equilibrium that is very difficult to alter. The case for decentralization, therefore, is overwhelming. More modest proposals call for the harmonization of tax bases, leaving tax rates in national hands. Yet, local preferences matter considerably when it comes to defining tax bases. The balance between the externality and local preferences is very uneasy to determine. Subsidiarity would then suggest to not seek centralization.

This has led to the more modest project to harmonizing tax bases. In principle, this would allow for more transparent comparisons of what member countries do. The intention seems to be to then use peer pressure to very gradually move to some degree of tax harmonization. However, it is hard to see how such a process of backdoor centralization could succeed. First, defining comparable tax bases is likely to be a challenging endeavor. This is an area where details crucially matter. The intricacies of national tax systems have produced a great many idiosyncrasies that will be difficult to meaningfully circumvent and impossible to eliminate. Second, what to do the tax rate differences that will emerge? In the absence of any acceptable prescription on what is an appropriate tax structure, peer pressure – already a weak process – is unlikely to produce much result. Taxation is bound to remain fully decentralized.

5. Budget Balances and Fiscal Discipline

5.1. THE IMPORTANCE OF FISCAL DISCIPLINE

The preference for limited explicit transfers calls for attention for implicit or involuntary transfers. The obvious concern is that sub-central governments run budget deficits and accumulate debts that they eventually can no longer honor. This could force the central government or the central bank to step in and provide indirect transfers. Such a process – known as the soft budget constraint – represents potentially a large-scale externality; it is well understood as a case of moral hazard.

A large literature is devoted to this question. It has identified a number of factors that encourage sub central governments to run up their indebtedness.[8] Unsurprisingly, they emphasize political and economic institutions. The list includes the nature of the relationship between government levels, the influence of regional interests in the central government, the pre-eminence of the Finance Minister in the budgetary process, political stability and length of time in office, and the ability of markets to impose discipline. The literature has also shown the importance of fiscal discipline at the central level and the existence of vertical transfers and the role of borrowing restrictions at the sub central level.

5.2. THE SPECIFIC CASE OF THE EUROZONE

The creation of the Eurozone has brought these issues to the fore. The Delors Report (1989) explicitly recognized the necessity for member states to be fiscally disciplined. This requirement was written in the Maastricht Treaty in the form of the Excessive Deficit Procedure (Art.126 of the TFEU). The Stability and Growth Pact (SGP) is an evolving set of guidelines set according to Art. 121 of the TFEU. The SGP is that it entrusts the Commission with the task of monitoring member states budgets and it allows the Council of Finance Ministers to take action, including imposing policy actions and imposing a fine, upon recommendations from the Commission.

This arrangement is surprising. Indeed, the EU has few attributes of a federal state, the Commission's budget is minimal and its revenues are provided by member states, not raised by centralized taxes, and yet it is formally authorized to censor national fiscal policies. According to an official survey of OECD countries, Sutherland et al. (2006) report that "the most common fiscal rule is the budget balance requirement […] Most sub-central governments also face a restriction on borrowing. There has been a move in a number of countries away from micro-management through a prior
approval system on a case-by-case basis towards aggregate and numerical targets. […] Borrowing is rarely explicitly guaranteed by a higher level of government, but implicit guarantees may be more widespread. […] Few countries apply fiscal rules directly to sub-central government spending." A summary of the findings is

[8] An early contribution is Wildasin (1997). For a clear statement and references, see Oates (2006) and the update in Sas (2014). For a recent empirical study and references, see Sas (2014).

presented in Table 2 below. It appears that the SGP is both more encompassing and intrusive than what is found in federal and unitary states.

Table 2 Centralization of budget restrictions and sanctions

	Balanced budget rule			Restrictions on borrowing		Sanctions		
	Centrally imposed	Negotiated	Self imposed	Numerical	No central guarantee	Impose action	Impose sanction	Escape clause
Austria		x			x		x	x
Canada			x	x	x	x		x
Czech Republic				x		x	x	x
Denmark				x	x		x	
Finland								
France				x	x	x		
Germany			x	x	x			x
Iceland				x	x			
Japan				x	x	x		x
Korea				x	x	x	x	x
Netherlands				x	x	x		
Norway					x	x		
Poland				x		x	x	x
Portugal				x	x	x		x
Spain		x		x	x			
Spain				x	x			
Switzerland			x	x	x			
Turkey				x		x	x	

Note: The survey seldom distinguishes between regional (states, provinces, regions, etc.) and local (municipalities) authorities. When the distinction is available, mostly for Canada, Germany and Spain), the table only reports on regional authorities.

Source: Sutherland et al. (2006)

Arguing for the SGP is the presence of the strong externality that has been evident during the sovereign debt crisis, confirming the conclusions of the Delors Report. In addition, fiscal policy coordination is justified by another externality, the fact that one country's cycle affects others. Yet, the fact that the sovereign debt crisis occurred is enough to establish that the SGP has failed to deliver. Is this *prima facie* evidence of failure a violation of the principles of fiscal federalism? Not necessarily, since the fiscal discipline set-up is subject to the classic tradeoffs.

Indeed, as long as prices and wages are mainly driven by domestic factors, business cycles will not be synchronized. Purely domestic factors such as labor and product market institutions as well as trade specialization, which significantly differ from one country to another, explain the lack of a high degree of synchronization.[9] Since, within the Eurozone where a single monetary policy, fiscal policy is the only remaining macroeconomic instrument left at national level.

In addition, strong asymmetric information and preference divergences must be factored in. Fiscal policy is an intensely political instrument and therefore a key prerogative of national governments. It lies at the heart of

[9] There is a vast, rather inconclusive, literature on business cycle synchronization in the Eurozone. A recent pre-crisis survey is De Haan et al. (2006).

domestic politics, hence the information asymmetry. Furthermore, budget imbalances imply redistribution across generations, which involves deep preferences. Preferences are shaped by a host of national factors including demography, the structure of family ties, traditions and taxation of bequests, and more, all of which are the outcome of history. Even though these preferences are combined with unhealthy myopia – the common pool problem at the heart of fiscal indiscipline – the solution must come from within. It calls for formal or informal rules and institutions. Von Hagen et al. (2009) convincingly argue that, to be effective, fiscal discipline rules must be tailored to national specificities and must therefore differ across countries.

The tradeoff is clear. Each Eurozone member country needs to recognize that fiscal discipline at home is a matter of utmost importance to all other members. This is explicitly stated in Art. 121 of the TFEU. At the same time the design and enforcement of appropriate rules cannot be uniform, as required by Art. 126. The authority conferred by this article to the "Center", the combination of the Council and of the Commission, is in direct contradiction with the fact that fiscal policy is a national competence. This contradiction was always bound to lead to serious difficulties when conflicts would arise between the SGP requirements and national intentions. The experience so far is that national sovereignty prevailed in such instances (the 2004 abeyance decision, *de facto* suspension of the pact during the crisis).

The question is how to escape this contradiction. The approach adopted in the wake of the crisis has been to strengthen the power of the Center. This has been achieved with the Six Pack-Two Pack legislation and the Treaty on Stability, Coordination and Governance (TSCG) also known as the Fiscal Compact. The obligations of Eurozone member states have been extended to detailed *ex ante* reporting (the European Semester and submission of budget laws before they are presented to national parliaments), to new obligations to reduce public debts when they exceed the 60% threshold and to new sanctions. In addition, key decisions are to be taken by reverse qualified majority voting: a Commission proposal is accepted unless a qualified majority votes again. This last feature intends to tilt the balance from the Council to the Commission. These revisions raise the stakes of the conflict between mutually agreed obligations and sovereignty. It can be argued that, by agreeing to these changes, member governments have willingly given up some sovereignty. It is not clear at all that this indeed was the case, nor that national parliament and citizens were aware that it could be the case. As a result, the matter is becoming highly political, a promise of politicization of the SGP.

This evolution implies that the externality argument is believed to overweigh the two other arguments against centralization, information asymmetries and preference divergences. This, of course, is a matter of judgment. But do we need to face this sharp trade-off? Wyplosz (2013) argues that the relevant example is the case of states in the United States. Table 2 shows that few countries operate centrally imposed rules. Sanctions are quite widespread but they mostly concern the municipality level. Yet, in most countries in the sample, sub central governments are subject to fiscal rules.[10] This points to the importance of self-imposed incentives. With one exception, all US states have adopted balanced budget rules, varying in details from state to state. Inman (2003) reports that this only happened after Congress rejected one more bailout request in the 1840s. This conforms to

[10] It is not clear at all how these rules have come into being. A possibility is that the table does not distinguish between the top layer of subcentral government (regions, states or provinces) and lower levels (municipalities) in the restriction columns while the balanced rule mostly concerns the first layer, which is relevant for a discussion of the SGP.

the indication in Table 2 that most countries do not guarantee sub-central government borrowings.

This is not the route taken in the Eurozone. Although Art. 125 of the TFEU strictly forbids bailouts, bailouts were repeatedly decided by the European Council. The EFSF, and its permanent successor, the ESM, are bailout institutions, *de facto* if not *de jure*. Paradoxically, this is in line with the US experience. As is well known, the first US Treasury Secretary, after independence Alexander Hamilton was eager to expand the realm of the federal government. One of his means was to bail states out when they met their budget constraints. Repeated defaults were averted that way, allowing the Treasury to acquire power, until Congress relented. The Eurozone bailouts and the creation of the EMS similarly expand the power of the Commission. They served as the motivation for the reforms of the SGP.

A crucial difference is that the US Treasury was able to grow, raising more taxes and expanding its budget, which the Commission cannot do. Moral hazard ensued as the states embarked on expensive infrastructure projects (chiefly building canals) that were not necessarily justified given that the Federal Treasury would eventually pick up the costs. The Kentucky decision was followed by a wave of defaults, affecting nine of the 28 existing states. In the Eurozone, the bailouts took the from of additional debts, leaving the affected countries with a burden that, at best, will weigh on economic conditions for decades to come.

This means that the Eurozone has even more reasons than the USA to let every member country design and enforce its own fiscal discipline rules and institutions.[11] Crucially, the no-bailout rule must be somewhat reinstated. Indeed, if the same causes produce the same effects, the certainty that bailouts are a thing of the past should lead member governments to become fiscally disciplined. The Fiscal Compact already requires each member country to operate a solid fiscal rule under the supervision of an independent fiscal council. The implementation so far seems uneven, with few countries having made written it in their constitutions or having adopted rigorous and enforceable rules (Burret and Schnellenbach, 2014).[12]

5.3. IMPLICATIONS FOR MONETARY POLICY

A difficult aspect concerns the role of the ECB. It is also bound by a no-bailout rule (Art. 123) and yet it has been part of the bailouts of 2010-2011. If the no-bailout rule is to be restored, this should also concern the ECB. In the US model, the central bank is strictly prohibited from purchasing state (and lower level of government) debts, including in its routine money market operations. The reason is that states are presumed to be allowed to default if their debts become excessive. The Federal Reserve therefore should not be in a position to suffer the corresponding losses, which would be a form of federal bailout. As a result, US Treasury bills and bonds are the monetary policy instruments of the Federal Reserve. In the Eurozone, there are no corresponding instruments, which necessarily exposes the ECB to country default risk.

[11] This is also the conclusion reached by the IMF: “Supranational controls are not sufficient to ensure fiscal discipline at the national level, as credible enforcement has also to take place at the level where fiscal sovereignty is exerted.” (IMF Country Report No. 14/198, p.12.
[12] As of the time of writing, the European Commission has not yet evaluated the implementation of this part of the Fiscal Compact.

This point simply means that there can be no single monetary policy without a single instrument to carry money market operations. The amount of securities held by the ECB for monetary operations is of the order of € 600 billion,[13] but it previously reached a peak of almost € 1300 billion in mid 2012. The total of gross public debts of Eurozone countries is about € 9540 billion.[14] If 20% of this amount were converted into a joint-liability of all Eurozone countries, with seniority over the rest of public debts, that would be more than enough for the most extreme cases experienced during the crisis. This would constitute of pool of very safe bonds available to the ECB for its monetary operations.[15] Debt mutualization is often, and rightly criticized for its adverse moral hazard effect. On the other hand, the ECB is taking risks with the instruments that it deals with – not just public but also private debts. This is obvious for purchases, which are the raison d'être of OMT even though no purchases have yet happened. It is also the case for repurchase agreement even though it applies significant haircuts, but these haircuts may prove to be insufficient. In a way, the ECB effectively mutualizes these instruments, simply because there is no substitute.[16] It is illogical to criticize the ECB for that while rejecting any proposal to provide the ECB with a European debt instrument.

[13] Source: ECB.

[14] Source: AMECO on line.

[15] Proposals to create safe Eurozone bonds have been previously advanced by Delpla and von Weizsäcker (2010) and Brunnermeier et al. (2011). Their intention was, however, to deal the sovereign debt crisis and they aimed at a much larger pool of bonds. Hellwig and Philippon (2011) propose issuing Eurobills up to 10% of total debts to avoid liquidity crisis, even though these could be monetary policy instruments. Beetsma and Mavromatis (2014) formally examine the discipline effects of Eurobonds.

[16] The only alternative would be to operate only with public debts deemed to be safe. For instance, the gross German public debt stands at € 2160 billion. This however would be technically difficult and politically contentious. Holding half of the German public debt could also be seen as a moral hazard.

6. Allocation of Competences

The focus so far has been on fiscal policy but the EU carries out some important functions. It has power – exclusive competence – in some very important economic areas: monetary policy (Eurozone only), competition, commercial policy and the conservation of maritime resources. It has also shared competences in a number of areas, including the internal market, consumer protection, transport and energy and, in a lesser way, R&D. In this respect, the EU has important federal attributes.

6.1. POLICY AREA AND FISCAL FEDERALISM

How do these common policies square with the principles of fiscal federalism? Table 3 presents a simple evaluation. For each EU exclusive or shared competence, the table attempts to identify which principle(s) justify transfer of competence and which one(s) argue in the opposite direction. Policy failure describes either of two cases. First, when local conditions or capture by private interests argue in favor of centralization on the sometimes dubious assumption that the failure will not occur at the EU level. Second, when the failure occurs at the EU level, so that a transfer of competence is ill-justified. Two stars indicate that the case is strong, no star when it is weak. The table is no doubt highly debatable as it involves personal judgment.

Table 3 Allocation of competences and fiscal federalism principles

	Pro centralization	Against centralization
Exclusive EU competence		
Monetary policy	Externality**	Local preferences*
Competition	Externality, effectiveness**, policy failure**	
Commercial policy	Externality**, policy failure**	Local preferences*
Conservation of maritime resources	Policy failure	Local preferences*
Internal market	Externality**, effectiveness**	Asymmetric information*, local preferences*
Shared EU competences		
Social policies	Externality	Asymmetric information**, local preferences**
Cohesion	Externality	Asymmetric information**, local preferences, policy failure**
Agriculture & fisheries	Externality, policy failure*	Asymmetric information*, local preferences**, policy failure**
Environment	Externality*, effectiveness, policy failure*	Local preferences**, policy failure*
Consumer protection	Policy failure*	Asymmetric information**, local preferences**, policy failure*
Transport	Externality**, effectiveness**	Asymmetric information**, local preferences**, policy failure
Energy	Externality*	Asymmetric information, local preferences**, policy failure
Freedom, security and justice	Policy failure	Asymmetric information**, local preferences**, policy failure
R&D	Effectiveness**, policy failure*	Local preferences
Outer space industry	Effectiveness**	Local preferences*
Development & cooperation	Effectiveness, policy failure*	Local preferences**, policy failure*
Humanitarian aid	Effectiveness, policy failure*	Local preferences**, policy failure

According to the table, exclusive competences are mostly well justified where it has been achieved. The case for the common conservation of maritime resources is the least convincing. The situation regarding shared competences is less clear-cut. The list includes some difficult areas, such as transports, where strong pros coexist with strong cons; the solution involves multi-tiered arrangements, separating local and pan-European connections, as should be. Value-related areas (social policies, cohesion, humanitarian aid and freedom, security and justice) are hardest to justify, especially when local preferences are naturally bound to vary from one country to the other. The subsidiarity principle suggests that there is little scope for further centralization.

6.2. STRUCTURAL REFORMS

Structural reforms are intended to improve the functioning of the economy, delivering better productivity and higher standards of living as well as lower structural unemployment. They are the mother's milk of macroeconomics: if well designed, they can do no harm and possibly much good.

Reforms, however, invariably hurt special interests. Indeed, they aim at removing market and policy failures, most of which are the result of past successful lobbying. Quite often, a market failure – e.g., natural monopolies or domination of monopsonist employers over employees, non-marketable public goods – are replaced by a policy failure that provide few people with a rent paid by a great many. Reforms involve pitting highly determined rentiers against a silent and generally unaware majority. Reforms may be Pareto-improving, but they amount to income redistribution and Pareto side payments are rarely on offer. As such, structural reforms are inherently political and require elected officials to organize these income transfers.

Unsurprisingly, governments are reluctant to carry out divisive reforms, whose political costs are immediate and highly visible while the returns accrue over long horizons and are often hard to detect. Incentives may be required. It is quite natural, therefore, to envisage external pressure to untie domestic knots. The EU has moved in that direction.

It started with soft cooperation (the Lisbon Process and then Agenda 2020). The SGP reform has moved to harder incentives since lack of progress on bringing public debts down can be compensated by structural reforms. The results from soft cooperation have been disappointing, in spite of the formalized procedure that has been set up. Fiscal federalism principles suggest that there are good reasons for that to be the case (Tabellini and Wyplosz, 2004). It is surprising, therefore, that Juncker et al. (2015) propose a whole new range of procedures and instruments to promote structural reforms in the Eurozone. At no point, however, the five presidents provide any justification for this centralization step. Observing, as they correctly do, that structural reforms are needed to promote prosperity, is a far cry from justifying further centralization. It is worrying to note that they seem unaware of the principles of fiscal federalism.

The idea of using external incentives to encourage difficult domestic action is quite natural. Using external pressure as a scapegoat is a time honored practice, but it can have a drawback. The external agent is resented if it seen as infringing into domestic affairs. This is most visible with IMF conditionality. However IMF conditions are imposed during a temporary period. Thereafter, the threat of an IMF return can further be used to support useful but unpopular reforms and policies. Within the EU, the situation is radically different. The EU is not meant to "leave the country". Resentment towards EU imposed policies can turn into against EU membership. Politicians can use this to campaigns aiming at leaving the EU instead. This is not a fanciful prospect anymore.

If, then, the external agent of change argument is of doubtful value, we should revert back to traditional fiscal federalism arguments. Are there solid enough externalities or returns to scale to over-ride the powerful information asymmetries and heterogeneities that characterize structural policies? This question requires examining more precisely the externality issue.

A negative externality occurs when one country's policy produces adverse effects in other countries. In that case, there is always too much of it (it produces a Nash equilibrium) and cooperation will help out. When one country enacts productivity reforms, it gains a comparative advantage over its trade partners. When the exchange rate is fixed, the effect is not mitigated. The unreformed countries will face a slump and, eventually, their prices and production costs will have to decline relatively to those in the reforming country. Should we conclude that reforms should be discouraged in a monetary union?

The answer cannot be positive, of course. The EU answer is to encourage non-reforming countries to follow suite. It is important, however, to note that the incentives operate in the right direction, based on competition and market pressure. The more some countries reform their economies, the stronger are the incentives to conduct reforms in the other countries. The spirit is one of experimentation and the adoption of best practice. In a way, this is what the Lisbon strategy was about. Going further, as with the new SGP, reflects disappointments with the strategy. However, this disappointment does not justify further centralization because it involves the center into deeply political sub-central issues, for which information asymmetries and local preferences are very important.

This conclusion carries even further. From an economic viewpoint, the EU is a commitment to integrate markets, and the monetary union is a commitment to not use exchange rates strategically and to support financial integration. This should lead to higher economic growth, *ceteris paribus*. But there can be no presumption that the result will be a convergence of growth rates or of unemployment rates. At best, one can hope for a convergence of standards of livings as catch-up forces are less hindered. There is no presumption either that all countries will pursue common structural policies. After all, a country should be free to undergo an economic decline is that is what its citizens collectively wish, including by not undertaking necessary reforms, as long as they respect the four freedoms.

7. Conclusions

Since its creation, European integration has been a process of gradual centralization. A re-evaluation of the current situation is likely to identify areas where more centralization is desirable, but there may exist other areas where less centralization is needed as well. This would represent a major new approach to integration, not seen as transfers from member states but as improvements to the overall architecture that happen to in the reverse direction. While this is mainly a political process, some conclusions stand to be drawn from the relevant small literature (Tanzi, 1996).

The "even closer union" has always been an ambiguous objective. There has never been an agreement on what the end of the road should be, and disagreements about an evolution towards federalism are as deep as ever. Of course, many Europeans dream of going into this direction, for many good reasons. This dream, however, must be widely shared by the citizens. Stealth integration has worked well in the past – the single currency is a shining example – but it is unlikely to work in the future, for several reasons.

First, the low-hanging fruits have been picked. More integration involves deeper sovereignty transfers.[17]

Second, citizens are more aware now of the trade-offs of further integration. The failed attempt at adopting a Constitution has revealed the end of the "pioneer period" when European integration was automatically seen as an end by itself.

Third, collective policy mistakes have dented the perception that European integration is raising welfare. The impact of the mismanagement of the sovereign debt crisis, as described in Wyplosz (2014), has been dramatic. In both the affected countries and the other ones, the memory of this historical event will linger for generations, as all traumatic events have always done.

Finally, in every country, the elites are seen with increasing suspicion. European integration has always been pursued by the elites. This association is now backfiring in almost every member country, and it affects citizens' consent to transfers of sovereignty to the EU.

This means that the objective of "an ever closer union" must now be replaced by the objective of "a more perfect union". The "bicycle theory of integration" is not based on any established theory; rather, as stated by Moravcsik and Nicolaidis (2005), it is a rhetorical statement that is "both misleading and unproductive". The challenge is to make the EU work better. After half a century of construction, the EU is a spectacular success but it has its defects, as any institution. It is more cleaning-up time than further integration time.

The current state of public spending centralization is the result of history, partly well thought through, partly the

[17] This point is well stated by Moravcsik and Nicolaidis (2005): "The central problem is that the EU will not – and, even in the wildest dreams of its enthusiasts – become the primary forum to address the issues that matter most to voters: "taxing and spending" issues like fiscal policy, social welfare and pension reform, medical care, infrastructure, defence procurement, and education, as well as immigration and cultural policy."

outcome of particular events long gone such as the transformation of Europe from largely rural economy to a modern economy where farmers represent a small fraction of the labor force or the wave of enlargements in the 1990s. Dedicating much of the EU budget to the CAP and the Cohesion policy made sense at some point. The logic has now disappeared but powerful interest groups have emerged to preserve these programs. On the other hand, a centralized research budget rips the benefits from significant returns to scale with no local preferences or information asymmetries. Much progress has been achieved in this area, but interest groups prevent a full transfer, often in the name of industrial policies that conflict with the Single Market.

With a budget very limited in size, most of the EU power derives from transfers of sovereignty on a number of explicitly designated areas as well as from creeping centralization in the name of fiscal discipline in the Eurozone. The Single Market is arguably the most spectacular success of European integration. It fully justifies sovereignty transfers in a number of areas, including the four freedoms and competition policy. Other areas of full or shared competences are less obvious. Public opinion is regularly alerted to European-level decisions that provoke outrage because they are perceived as needless entrenchments on national sovereignty.[18] The justification of outrage is that ordinary citizens do not see any way to challenge European-level decisions while similar national-level decisions can be quickly reversed as the result of strong rejection. While most such decisions are anecdotal, the political impact should not be underestimated. A thorough overhaul is called for.

The Single Currency is a more ambiguous success. The case for centralization is weaker. Importantly, the crisis has shown that a common currency requires more than a shared currency and one central bank. Bank regulation and fiscal discipline were either ignored or poorly thought through in the Maastricht Treaty. The Banking Union fills a major oversight and will have to be completed. Fiscal discipline is thoroughly needed, but centralization is not necessary. A revision of the SGP is called for. The main objective must be to decentralize both the design of fiscal rules and their implementation, while restoring the no-bailout clause. Ignoring this clause has opened the way to further centralization, which is a major source of conflict and an approach that will ultimately fail. In addition, adding structural reforms to the SGP package mixes up fiscal discipline and unrelated but important issues, while laying the ground for further conflicts.

It is of course impossible to deal with the whole architecture of the EU in one paper. The thread line here is the usefulness of fiscal federalism principles. These principles involve trade-offs so they are flexible and call for judgment. They would be a good place to start from.

[18] A frequently mentioned example is Directive 2001/45/EC, which edicts how ladders should be used. The official text dutifully notes that "this Directive is the most appropriate means of achieving the desired objectives and does not go beyond what is necessary for that purpose" and that "this Directive is a practical contribution towards creating the social dimension of the internal market."

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