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Will Fiscal Policy Be Effective Under EMU?

Prepared by Marco Cangiano and Eric Mottu[1]

Authorized for distribution by Richard Hemming

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Abstract

European Economic and Monetary Union does not envisage creating a central fiscal authority. Monetary and exchange rate policies will be centralized, but fiscal policy will remain a national responsibility, in line with the subsidiarity principle. This paper argues that monetary union will generate pressures for closer economic integration than currently envisaged. Although not a necessity, a more active central role could then be justified on the grounds of allocative efficiency, redistribution, and stabilization. While in the short term enhanced policy coordination may address those pressures satisfactorily, as economic integration proceeds, the case for a central fiscal authority may become stronger.

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Authors' E-Mail Address: mcangiano@imf.org, emottu@imf.org

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Summary

The third stage of European Economic and Monetary Union (EMU) will see the creation of a common currency, the euro. Like most monetary unions, but distinct from sovereign federations in which currencies and nations coincide, EMU will not have a central fiscal authority. Although monetary and exchange rate policies will be fully centralized, fiscal policy will remain largely a national responsibility, in line with the subsidiarity principle. Fiscal policies will be coordinated through the multilateral surveillance and excessive deficit procedures of the Maastricht Treaty, as clarified in the Stability and Growth Pact. As such, the EMU policy framework is closer to that of a federation than of a pure monetary union, although it is one of coordination of fiscal policies rather than one of a federation comprising a central fiscal authority.

Adopting a common currency represents a decisive step for participating members toward closer integration. The emergence of European public goods, along with increasing tax competition generated by greater price transparency, however, could require closer coordination of policies. With increasing factor mobility, redistribution policies of member states could become ineffective; a more centralized policy, despite different preferences among countries, may become not only possible but necessary in the longer run. The absence of an EMU central fiscal authority implies that policy coordination will continue to rely on existing institutions. However, the ECOFIN Council may not be able to act as effectively on fiscal policy as the European Central Bank on monetary policy. The paper concludes that it is necessary to enhance fiscal policy coordination for the smooth operation of EMU in the immediate future. Over the medium term, however, closer policy coordination may not be sufficient given the growing demands and needs of economic and monetary integration. Creating a central fiscal authority—possibly endowed with larger financial resources than the current EU budget—may then be desirable.

I. INTRODUCTION

The commencement of the third stage of the European Economic and Monetary Union (EMU) on January 1, 1999 will see the creation of a common currency, the euro. The scope for independent national monetary and exchange rate policies will disappear, and their design and conduct will become the responsibility of the European System of Central Banks (ESCB). The primary objective of the ESCB, which is comprised of the European Central Bank (ECB) and the national central banks of the eleven EMU participants, will be to maintain price stability. As the central bank of the euro area, the ECB will have a high degree of independence and accountability, and will be prohibited from directly financing governments and European Union (EU) institutions.

Like most other monetary unions (e.g., the CFA franc zone), but as distinct from sovereign federations in which currencies and nations coincide, EMU will not have a central fiscal authority. Although monetary and exchange rate policies will be fully centralized, fiscal policy will remain largely a national responsibility, in line with the subsidiarity principle.[2] Coordination of fiscal policies will take place through the multilateral surveillance and excessive deficit procedures of the Maastricht Treaty (Articles 103 and 104c), as clarified in the Stability and Growth Pact (SGP).

The overall EMU policy framework is clearly closer to that of a federation than to that of a pure monetary union.[3] However, observers believe that the absence of a central fiscal authority will not pose major problems. They argue that the SGP strikes an appropriate balance between rules and flexibility in the conduct of national fiscal policies (IMF, 1997). In addition, several features of EMU—the loss of national control over monetary policy, the sharing of seignorage, and the strengthening of market-based discipline—should instill fiscal discipline among member states, assuming that a country that behaves unresponsibly will not be bailed out. But other observers contend that national economic developments have spillover effects on inflation prospects and monetary conditions in the whole euro area, and the move to a single currency therefore requires closer community surveillance and coordination of fiscal policies. It is for this reason that several EMU member countries have

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[2]Although initially the euro area will not include all EU member states, it will operate within the EU institutional framework.

[3]As such, EMU certainly constitutes a "fundamental regime change that will modify the structural parameters of national economic systems and, hence, the differences across countries" (European Commission, 1997). Also see Hemming and Spahn (1997) for a discussion of fiscal federalism in the EU.

pushed for the creation of a new Euro Council, the so-called Euro-11, to ensure better coordination of economic policies in the euro area.[4]

The purpose of this paper is to describe how fiscal policy will be conducted under EMU, and in the process to consider whether a well-functioning monetary union requires a central fiscal authority. The paper concludes that it is necessary to enhance fiscal policy coordination for the smooth operation of EMU in the immediate future. Over the medium term, however, closer policy coordination may not be sufficient given the growing demands and needs resulting from economic and monetary integration. Creating a central fiscal authority—possibly endowed with larger financial resources than the current EU budget—may then be desirable. The paper is organized as follows: Section II reviews how basic fiscal functions are assigned and carried out in existing federal states and in the EU, with a view to emphasizing the differences between them. Section III takes a closer look at the assignment of fiscal functions within the EMU institutional framework. After briefly discussing topics including the subsidiarity principle, the status of tax harmonization efforts, and the adequacy of the European structural funds in addressing redistribution policies, the paper revisits the debate on the SGP. The case for enhanced coordination, and possibly a central fiscal authority, is also discussed. Section IV contains some concluding remarks.

II. The Basic Functions of Fiscal Policy in a Federation and in the EU

It is often argued that the EMU policy framework is closer to that of a federation than to that of a pure monetary union. Prior to discussing the EMU's envisaged fiscal policy framework, this section provides some general background on how basic fiscal policy functions are assigned across different levels of governments in existing federations and in the current EU institutional setting. It concludes that the EU fiscal framework is one of coordination of fiscal policies rather than one of a federation comprising a central fiscal authority.

Fiscal policy in existing federations: stylized facts

The three basic functions of fiscal policy—allocation, redistribution, and stabilization—can be assigned differently across levels of governments. The traditional theory of fiscal federalism, while leaving open the assignment of the allocation functions, concludes that redistribution and stabilization should be conducted at the central level. The arguments are summarized in Box 1. In existing federations, the three basic functions of fiscal policy are carried out largely by central governments, although with varying degrees of participation from intermediate and local governments. This is because most of the spending is related to

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[4]Although the European Council has recently adopted a resolution whereby the ECOFIN (Council of ministers of finance or economic affairs of the European Union)—comprising all EU member states—would remain the only decision-making body for economic coordination.

Box 1. Fiscal Federalism and the Basic Functions of Fiscal Policy

The three basic functions of fiscal policy—allocation, redistribution, and stabilization—can be differently assigned across levels of governments. In pursuing *allocative efficiency*, three criteria are usually considered for centralizing or decentralizing the provision of public goods: their spatial incidence; the existence of uniform or differentiated preferences across subcentral governments; and the presence of economies of scale. Public goods having effects on the entire federation are typically provided at the central level. Indeed, only if the jurisdiction that determines the level of provision of public goods includes precisely the set of individuals who consume the good, will there be a correspondence between provision and consumption (Oates, 1972). A corollary—the so-called fiscal equivalence (Olson, 1969) or accountability principle—is that there should be a direct link between the benefits of public expenditures and the taxes levied to finance them, thus promoting fiscal responsibility and enhancing allocative efficiency and equity. When preferences are differentiated, local provision of public services can be efficient if individuals are mobile and "vote with their feet," thus choosing the combination of services and taxes closer to their preferences (Tiebout, 1956).

The *redistribution function* should be carried out at central government level mainly because the mobility of individuals between jurisdictions would lead to a concentration of low-income earners in the most generous regions, eventually leading to an inability to finance the redistribution policy (Oates, 1972). Furthermore, centralizing redistributive policies can be justified to the extent that income distribution has the characteristics of a pure public good (Thurow, 1971), provided that a reasonable degree of consensus exists. There are, however, several counter arguments. First, mobility may not be very high, thus allowing for decentralized redistribution policy to be effective. Second, if preferences differ between central and subcentral governments, it may be optimal, on allocative efficiency grounds, to decentralize redistributive policies (Pauly, 1973). Third, costly information on the potential beneficiaries of policies may be collected more effectively by lower levels of government (Rocaboy, 1995).

The *macroeconomic stabilization* function should also be centralized. The main reason is that subcentral governments would not have the incentive to provide optimal stabilization, as they would free-ride on fiscal efforts carried out beyond their jurisdiction. From this standpoint, stabilization could be seen as a public good. In addition, local governments often have self-imposed statutory requirements to balance their budgets—because their access to capital markets is more limited—which prevents them from running countercyclical fiscal policies. They may also have different preferences over macroeconomic variables, such as inflation and employment, which would cause a genuine coordination problem. Finally, since business cycles may not be closely correlated, or since the magnitude and effects of shocks may vary among regions, intervention by the central government may lower the costs of smoothing out such asymmetric effects.

As to the *assignment of tax responsibilities*, several arguments favor centralizing revenue collection. Besides the economies-of-scale argument, centralization would prevent tax evasion induced by mobile tax bases, avoid excessive tax competition between subcentral governments, and guarantee taxpayers equal treatment in jurisdictions with different fiscal capacities. However, full centralization would not be ideal from the point of view of fiscal equivalence and accountability, so that some taxation powers may have to be decentralized, preferably on immobile tax bases. Allocative efficiency and equity would then require central governments to coordinate or harmonize these taxes, and that subcentral governments share information on taxpayers (Tanzi and Zee, 1998).

Tax and expenditure assignments may give rise to *vertical and horizontal imbalances* among jurisdictions. These imbalances can be addressed by revenue-sharing arrangements and intergovernmental grants. Revenue-sharing arrangements are usually carried out on a tax-by-tax basis, with specific distribution rules determining the allocation of revenue to each level of government. The distribution can be made on a derivation basis, with subcentral governments receiving part of the revenue collected in their territory, thus addressing exclusively the vertical imbalance. Alternatively, the arrangement can include elements of interregional redistribution, in which case it contributes to promoting horizontal equalization.

objectives—the provision of public goods, redistribution, and macroeconomic stabilization—that cannot be satisfied adequately by the independent actions of the states or provinces that make up a federation (Tanzi, 1995), and because centralization of tax responsibilities is generally more efficient and equitable. In the five largest OECD federations—Australia, Canada, Germany, Switzerland, and the United States—central governments spend, on average, more than half of total expenditure and collect about 60 percent of total revenue (Table 1, Figure 1, and Box 2).[5]

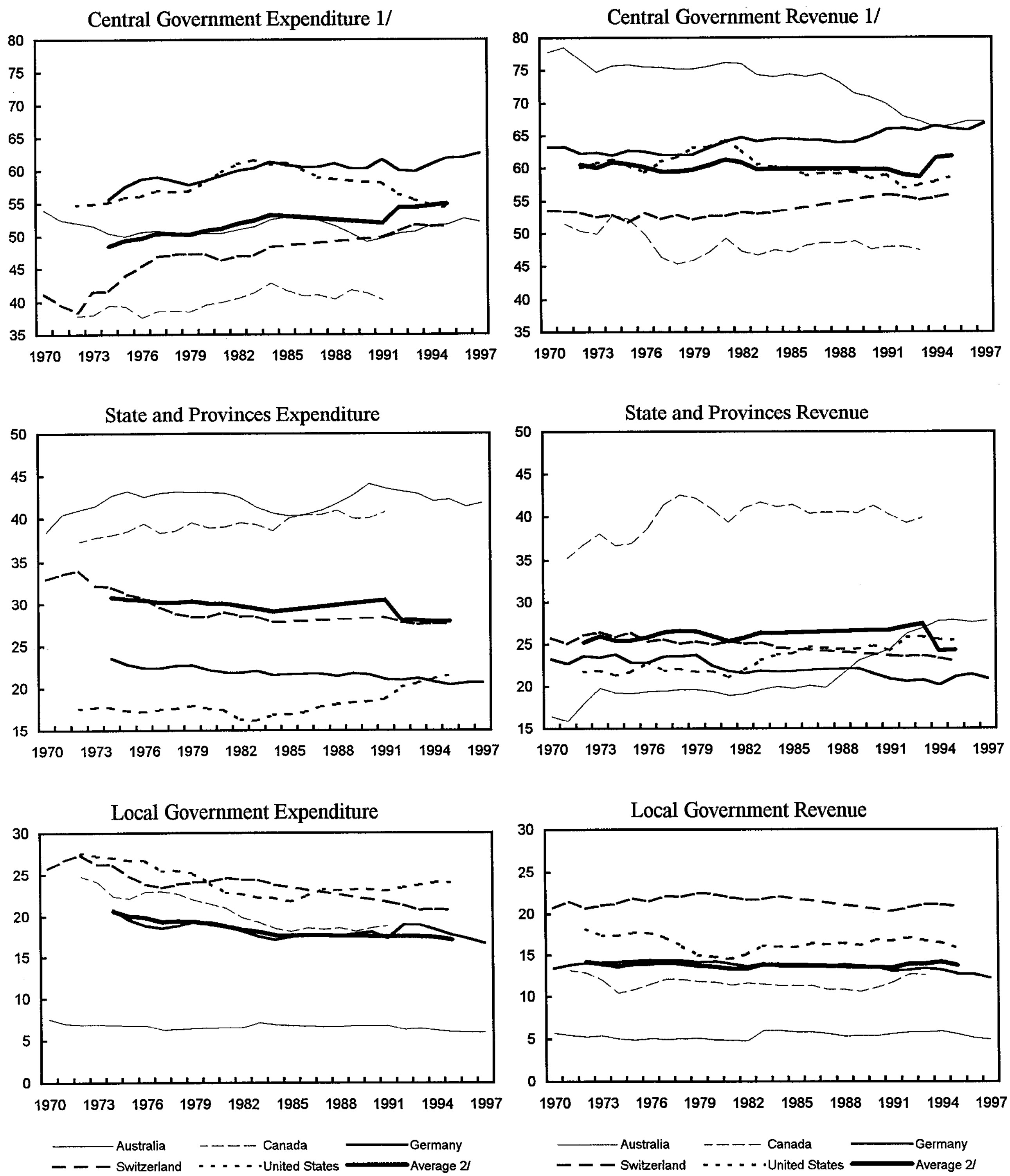
Table 1. Expenditure and Revenue Structure by Level of Government for Selected Countries

	Expenditure Net of Transfers			Revenue Net of Transfers		
	Central Government	States/ Provinces	Local Governments	Central Government	States/ Provinces	Local Governments
Australia (1995–97)	52.2	41.8	6.0	67.0	27.7	5.2
Canada (1990–91)	40.9	40.4	18.7	47.8	40.8	11.4
Germany (1995–97)	62.2	20.6	17.2	66.3	21.2	12.6
Switzerland (1993–95)	51.6	27.6	20.8	55.6	23.4	21.1
United States (1993–95)	54.9	21.1	24.0	58.0	25.6	16.4
Average (unweighted)	52.4	30.3	17.3	58.9	27.7	13.3
	Transfers from			**Transfers to**		
	Central Government	States/ Provinces	Local Governments	Central Government	States/ Provinces	Local Governments
Australia (1995–97)	90.4	9.4	0.2	0.0	94.5	5.5
Canada (1990–91)	51.2	48.6	0.2	0.2	49.7	50.2
Germany (1995–97)	35.6	56.8	7.6	2.3	42.4	55.3
Switzerland (1993–95)	51.7	30.1	18.2	31.7	48.3	20.0
United States (1993–95)	45.4	51.6	3.1	0.0	43.1	56.9
Average (unweighted)	54.9	39.3	5.9	6.8	55.6	37.6

Source: *Government Finance Statistics* and *International Financial Statistics*, International Monetary Fund, Washington.

[5]It is worth noting that historically, the federations have not always been monetary unions. Switzerland and Germany had several currencies in the first half of the nineteenth century. Switzerland had several dozen different currencies, both local and foreign, and each canton or city coined its own. These coinages were withdrawn in 1851—about the time internal customs borders were eliminated—and replaced by the new, harmonized franc.

Figure 1. Composition of Expenditure and Revenue by Level of Government
(Share of General Government)



Source: IMF, *Government Finance Statistics*, various years.

1/ Central government includes social security funds. Expenditure excludes net lending and is net of transfers disbursed; revenue is net of transfers received, i.e. general government excludes double counting of transfers.
2/ The average excludes Canada from 1992 onwards for expenditure, and from 1994 for revenue.

Box 2. Selected Features of the Largest Five OECD Federations

Australia is a federation with three levels of government: the Commonwealth, eight states or territories, and about 900 local authorities. It is characterized by large vertical imbalances between revenue and expenditure assignments at the national and subnational levels. Tax bases are clearly separated among different levels. Although it accounts for about half of public expenditure, the central government raises around 67 percent of total revenue. The vertical gap at the subnational level is filled by grants from the center, which represent 7 percent of GDP; half of them have an equalization component. Local governments account for only about 6 percent of public expenditure.

Canada is a federation with three levels, consisting of a federal government, 10 provinces, 2 territories, and nearly 5,000 local governments. The Canadian system is relatively decentralized and redistributive. The provinces account for about 40 percent of total expenditure, the local governments 19 percent. However, the provinces are somewhat dependent on federal grants, which represent about 4 percent of GDP; these grants include a strong equalization component. The three levels share the same tax bases; this leads to some difficulties in tax coordination and harmonization, especially for income and sales taxes.

Germany consists of the federal government, 16 states (*Länder*), and about 16,000 municipalities. Although the execution of public policies is highly decentralized, federal authorities set the policy guidelines and legislation. This has been labeled "the horizontal approach to federalism," as opposed to the Anglo-Saxon vertical model of stricter division of responsibilities. Taking into account social security, more than 60 percent of public expenditure is spent at the central level. Most taxes are shared between the federal and the state level; the various revenue-sharing arrangements and federal grants have a significant equalization component.

Switzerland is a federation of 26 states (cantons), and about 3,000 municipalities. The federal government plays a leading role in most policy areas, and spends about 50 percent of public expenditure (including social security). As in Germany, the states and municipalities are generally responsible for the implementation of these policies. The Swiss federal system is sometimes referred to as a "cooperative federalism." The tax base for income taxation is shared between the three levels of government, but indirect taxation is assigned exclusively to the federal level. There is also an extensive network of grants, both from the federal and the state level, usually with an important equalization component.

The **United States** consists of the federal government, 50 states, and about 83,000 local authorities. Subnational governments play an important role; however, the federal government has acquired a dominant position by funding a large part of public activity, mostly welfare and public works. All three levels have their independent sources of tax revenue, although they exploit the same base for income taxes. Subnational governments, especially the local ones, are heavily dependent on transfers from higher jurisdictions, which represent about 6 percent of GDP; these grants generally do not have an equalization component.

Canada is the most *decentralized* federation, having important provinces and noneligible local governments, while Germany and Switzerland are the most *centralized*, in part reflecting large central government social security systems. Australia and the United States are also relatively *centralized*. To address vertical and horizontal imbalances, federations rely on transfers, mostly from central to subcentral levels of government. Germany relies mostly on revenue-sharing arrangements, whereas other countries rely more on grants (Australia, Canada, and the United States). These arrangements, although allowing for decentralization to take place, tend to increase the effective degree of centralization by creating financial dependency on the part of subcentral governments.

Since the 1970s, with the exception of the United States, those federations have shown a tendency toward a greater centralization of expenditure. Overall, the share of the central government in total expenditure has increased by about 3 percentage points between 1975 and 1995 on average (Table 2).[6] Part of this centralization is due to increases in social security spending. There has been a marked tendency toward revenue decentralization in Australia and, to a lesser extent, in Canada and in the United States, but more centralization in Germany and Switzerland.

Table 2. Share of Central Government in General Government for Selected Federal Countries, 1975–1995 1/

		1975	1985	1995
Australia	Expenditure	50.0	52.8	51.8
	Revenue	75.9	74.4	66.6
Canada	Expenditure	38.5 2/	41.8	40.4 3/
	Revenue	52.2	47.3	48.0 3/
Germany	Expenditure	57.5	60.9	61.9
	Revenue	62.8	64.5	66.1
Switzerland	Expenditure	43.9	48.4 4/	51.7
	Revenue	51.7	53.3 4/	56.1
United States	Expenditure	55.9	61.2	54.4
	Revenue	60.4	60.1	58.7
Average (unweighted)	Expenditure	49.2	53.0	52.0
	Revenue	60.6	59.9	59.1

Source: IMF, *Government Finance Statistics*, various years.

1/ Central and general government include federal social security funds. Expenditure is net of transfers disbursed, revenue is net of transfers received.
2/ 1979
3/ 1991
4/ 1984

[6]While all five countries experienced centralization between 1975 and 1985, trends varied between 1985 and 1995 with Australia, Canada, and the United States (minus 7 percentage points) decentralizing, and Germany and Switzerland continuing their centralization.

Fiscal policy in the EU

Underpinning the EU philosophy is the subsidiarity principle. Introduced into European law in 1992 by the Maastricht Treaty, this principle states that *"... in areas which do not fall within its exclusive competence, the Community shall take action, in accordance with the principle of subsidiarity, only if and insofar as the objectives of the proposed action cannot be sufficiently achieved by the member states and can, therefore, by reason of the scale or effects of the proposed action, be better achieved by the Community."* (Article 3b of the Treaty on European Union). By expressing the presumption that the primary responsibility for public policies lies in the hands of the EU member states, the principle recognizes that countries are not ready to yield more fiscal authority to the EU than they do now. Accordingly, the main fiscal functions within the existing EU institutional framework are assigned differently than in the large federations discussed above. *Allocative efficiency* is pursued mainly through: the establishment of the single market, which involves the removal of fiscal frontiers; the mutual recognition of national standards, norms, and procedures (e.g., procurement and accounting); and the harmonization of indirect taxes while leaving other taxes to spontaneous harmonization (Kopits, 1992). The *redistribution* and *stabilization* functions are left largely to member states, with the EU budget providing for some limited redistribution through structural funds (aimed at financing regional and social policies designed to raise employment levels and close income gaps among EU regions (Boxes 3 and 4), the Cohesion Fund,[7] and the Common Agricultural Policy (CAP).

In line with the underlying philosophy, the size of the EU budget is relatively small;[8] in 1997, it was slightly less than 1.2 percent of the combined GNP of its member states and only 2.5 percent of their combined public spending. Total own resources called on by the EU are limited by a ceiling fixed as a percentage of total GNP. This ceiling is to rise progressively from 1.20 percent in 1994 to 1.27 percent in 1999. For the period 2000–2006, the financial perspectives outlined in *Agenda 2000* aim at financing the development of EU activities and the accession of a number of countries from Central and Eastern Europe while maintaining constant the available resources as a share of the European GNP (Box 5).

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[7]To address the potential worsening of regional disparities, the Maastricht Treaty established the Cohesion Fund to channel financial assistance to the four poorest states—Greece, Ireland, Portugal, and Spain.

[8]The EU budgetary authority is composed of two competing institutions, the Council of Ministers and the Parliament. The European Commission proposes each year's budget, which has to be adopted by the Council and, ultimately, the Parliament. Conflict between the Council and Parliament has been greatly reduced following an interinstitutional agreement reached in 1988. Renewed in 1993, it sets a seven-year framework for determining the size of the budget and spending ceilings for the main policy areas.

Box 3. The EU Structural Funds

The **European Regional Development Fund** (ERDF), established in 1975, is one of the key structural funds. Its assistance is limited to less-favored regions and is focused mainly on:

- productive investment to permit the creation or maintenance of permanent jobs;
- investment in infrastructure, which varies by objective (see Box 4), including trans-European networks for regions eligible under Objective 1;
- investment in education and health in the regions eligible under Objective 1;
- development of indigenous potential: local and small and medium enterprise development; and
- research and development measures, and investment linked to the environment.

The **European Social Fund** (ESF) concentrates on vocational training and employment assistance for the:

- long-term unemployed and young people in search of employment;
- integration of persons exposed to exclusion from the labor market;
- promotion of equal opportunities in the labor market;
- adaptation of workers to industrial change;
- stability and growth in employment; and
- strengthening of human potential in research, science, and technology.

The **European Agricultural Guidance and Guarantee Fund** (EAGGF) promotes the adjustment of agricultural structures and rural development measures, including the:

- maintenance of farming income and communities in mountainous or less-favorable areas, and start-up support for young farmers;
- improvements in the structural efficiency of holdings;
- establishment of producers' associations;
- conversion, diversification, and improvements in the quality of agricultural production;
- development of rural infrastructure and tourist investment; and
- prevention of natural disasters, village renewal, protection of the rural heritage, development of woodland, and protection of the environment.

The **Financial Instrument for Fisheries Guidance** (FIFG) promotes structural measures for:

- fleet modernization;
- development of fish farming;
- protection of some marine areas;
- facilities at fishing ports;
- processing and marketing of fishery products; and
- promotion of fishery products.

Box 4. Policy Objectives of the EU Structural Funds

Regional policy is very much a collaborative effort between the EU, its member states, and local and regional authorities. Financing from the structural funds is mainly used to support programs that are presented and managed by the relevant authorities in the member states. The **regional priority objectives** fall into four categories:

- **Objective 1**: promoting the development and structural adjustment in less-developed regions;
- **Objective 2**: converting regions or areas seriously affected by industrial decline;
- **Objective 5b**: facilitating the development and structural adjustment of rural areas;
- **Objective 6**: promoting the development and structural adjustment of regions with an extremely low population density.

The **nonregional priority objectives** of European cohesion policy are the following:

- **Objective 3**: combating long-term unemployment and facilitating the integration into working life of young people and persons excluded from the labor market, and promoting equal employment opportunities for men and women;
- **Objective 4**: facilitating the adaptation of workers to industrial changes and to changes in production systems;
- **Objective 5a**: facilitating the adjustment of agricultural structures to the reform of the common agricultural policy and promoting the modernization and structural adjustment of the fisheries sector.

Most of the EU budget has a clear interregional *redistributive* function (Figure 2). About half is spent on the CAP, and one third on the structural funds. Expenditures on internal policies, particularly research, education, and transportation, reached 6 percent in 1997, whereas spending on external actions and on administration amounted, respectively, to 7 percent and 5 percent.[9] The EU budget is financed via a revenue-sharing arrangement with member states. Unlike in other federations, EU revenue is collected by members and allocated to the EU level. There are four sources of financing: VAT revenue, the so-called GNP-resource, customs duties, and agricultural and sugar levies; these accounted, respectively, for 42 percent, 40 percent, 15 percent, and 2 percent in 1997. VAT revenue derives from the application of a uniform rate (which could not exceed 1.24 percent in 1996, and will decrease to 1 percent in 1999) to the member states' VAT bases. The "GNP-based resource" is proportional to each member's GNP and provides the required revenue to cover the

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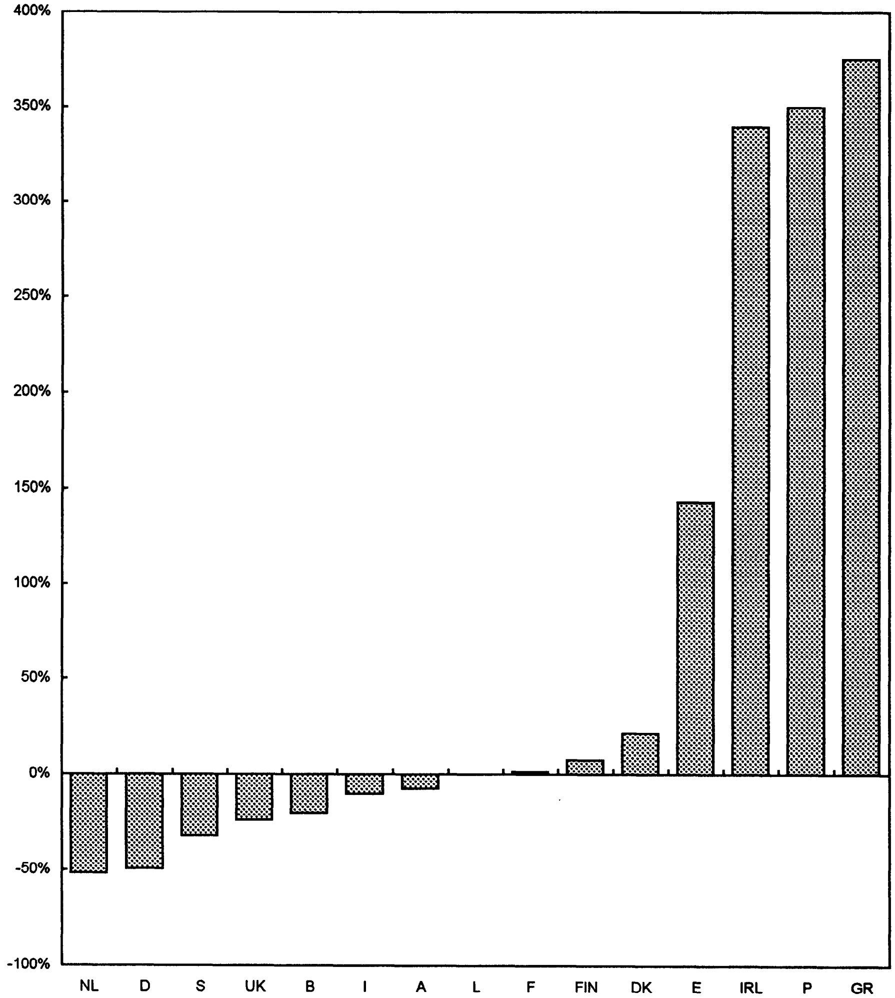
[9]The EU also makes loans with funds borrowed in capital markets, supported by guarantees from its general budget in four areas: (1) medium-term financial assistance to third countries; (2) European Atomic Energy Community (EURATOM) loans for promoting investment in nuclear energy; (3) balance of payments support for member states, such as Greece in 1991 and Italy in 1993; and (4) guarantees on loans granted by the European Investment Bank in third countries having signed protocols with the EU in Central and Eastern Europe, the Mediterranean basin and certain countries in Latin America, Asia, and in South Africa.

Figure 2. Net Incidence of EU Budget on Member States
(Estimated net gain in percentage of financing)



Source: European Commission, DG XIX, 1998.

difference between planned expenditure and the amount yielded by the three other sources. It has increased steadily since its introduction in 1988, reflecting a deliberate effort to increase the *equity* of contributions by countering the regressivity, both for taxpayers and member states, of VAT revenue. Customs duties are levied on trade with nonmembers. Agricultural levies are charged on imports of agricultural products originating in nonmember states. Sugar levies are imposed on sugar companies either to cover expenditures on market support or to regulate storage.

Box 5. Agenda 2000 and the Future Financial Framework for the EU

Agenda 2000, submitted to the European Council by the Commission in July 1997, outlines the development of EU policies beyond the turn of the century, including the impact of the envisaged enlargement on the Union as a whole, and the financial framework from 2000 to 2006. As to financial policy, it proposes maintaining the overall expenditure ceiling at 1.27 percent of European GNP while developing the EU's various policies. These proposals have yet to be discussed and approved by the Council and the Parliament.

Among other measures, *Agenda 2000* proposes to further develop EU internal policies in favor of growth and employment by focusing on trans-European networks (transport, energy, and telecommunications), research and innovation, education and training, environment-friendly technologies, and measures that support small businesses.

Agenda 2000 also aims at improving the effectiveness of EU structural policies while maintaining their current limit at ½ of 1 percent of GNP. Although structural funds allocated to regions undergoing major economic and social restructuring (Objectives 1 and 2) would be targeted to 35–40 percent of EU population rather than the current 51 percent, the qualifying regions would be allocated a larger share of total funds.

Main differences between the EU and existing federations

Three points emerge from comparing the fiscal policy frameworks of the EU and the OECD federations discussed above. First, the EU is much less centralized than the existing federations. Second, the EU still appears closer to a confederation of independent states—with distinct cultures, languages, and political and legal traditions—than a federation, despite the extension of the majority vote to an increasing range of policy issues.[10] Third, each member state remains accountable for its public finances, thus preventing the development of a large EU transfer budget justified by vertical imbalances—a feature that

[10]In a *confederation* the role of the central entity is to coordinate policies between sovereign governments, whereas in a *federation*, it has the power to make centralized policy decisions over subcentral governments. Although the EU judiciary system has the characteristics of a federal system, other EU institutions operate in ways similar to a confederation (Muet, 1995).

characterizes most existing federations and accounts for an important part of the growth of their central fiscal authorities.

The current EU fiscal framework is, therefore, one of coordination of fiscal policies rather than one of a federation comprising a central fiscal authority. Although federations in Europe have evolved toward centralization, several features of the existing EU framework aim in the opposite direction. The subsidiarity principle, in particular, may have counteracted the centralizing tendencies that exist in most "mature federations" (Hemming and Spahn, 1997). The small central budget did not provide the EU with an effective authority for any of the basic fiscal policy functions; on the contrary, it has made it dependent on its members' willingness to transfer powers and spending responsibilities.

Despite these observations, the EU framework is undoubtedly closer to a federation than the other existing monetary unions, like the CFA franc zone or the currency union between Belgium and Luxembourg. These unions are in essence quite similar to the euro area: they consist of a group of independent countries sharing a common currency managed by an independent central bank.[11] But they are only monetary unions,[12] unlike the euro area which is accompanied by a much closer political, judicial, and economic integration, a central budget, a process of harmonization of regulations and taxes, and policy coordination mechanisms.

III. A Closer Look at EMU and the Basic Functions of Fiscal Policy

The policy framework envisaged under EMU will not alter significantly the way basic fiscal policy functions are assigned in the current EU institutional setting. The purpose of this section is to assess whether the EMU policy framework provides clear procedures to ensure that fiscal policy is carried out effectively, in line with the requirements of a monetary union. After discussing the substance of the Maastricht Treaty and the SGP, this section revisits some of the issues that have been raised regarding the effectiveness, or lack thereof, of the EMU fiscal policy framework. Starting from whether the subsidiarity principle represents an obstacle to centralization, this section reviews the allocative and redistributive functions of fiscal policy, and discusses the status of tax harmonization, the possible emergence of EMU-related public goods, and the adequacy of the EU structural funds. Turning to the stabilization function and the debate on centralization versus decentralization, the section provides a survey of arguments that have been put forth in favor of or against the SGP. Given their

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[11]In fact, there are three separate banks in the CFA franc zone (Clément et al., 1996). Unlike the euro area, the zone does not have an independent monetary policy, since it is that of the French franc.

[12]Despite the fact that in one part of the CFA franc zone, the West African Economic and Monetary Union (WAEMU), countries have recently agreed on a common external tariff and intend to harmonize their budgeting procedures, accounting framework, and indirect taxes.

rising importance under the SGP, the section also provides a brief digression on automatic stabilizers, a matter somewhat neglected in recent empirical literature. Finally, the desirability of closer policy coordination and the possibility, over the medium run to establish a central fiscal authority are discussed.

The Maastricht Treaty and the Stability and Growth Pact

The Maastricht Treaty makes the *stabilization* function the prerogative of each member state, but subject to multilateral surveillance and excessive deficit procedures. The latter procedures have been clarified by the SGP.[13] The SGP calls for a medium-term fiscal position for EMU participating states that is close to balance or in surplus. As a general rule, a government deficit exceeding the reference value of 3 percent of GDP (stated in Protocol (5) to the Maastricht Treaty) is considered excessive and should be corrected, or financial sanctions will be imposed. However, the SGP allows deficits to *temporarily* exceed the 3 percent reference value under *exceptional circumstances*, such as a decline in real GDP of 2 percent or more in a single year. In addition, a participating member with a deficit in excess of the reference value may invoke special circumstances if the GDP decline is less than 2 percent. The participating members agreed in the European Council resolution to invoke special circumstances only if the annual fall of GDP is at least 0.75 percent. An excessive deficit must be corrected by the year after it has been identified (two years after it occurred).[14] If not corrected, the Council—acting by a qualified majority and based on a report from the Commission—may apply financial sanctions against the member, in the form of nonremunerated deposits[15] that may be converted into fines after two years of noncompliance. The SGP is administered and enforced by the ECOFIN Council.[16] In fulfilling its tasks, the

[13]The SGP, agreed in Amsterdam in June 1997 and adopted in July, consists of two Council regulations: the first is on the strengthening of the surveillance of budgetary position and the surveillance and coordination of economic policies (Council Regulation (EC) No. 1466/97), the second is on speeding up and clarifying the implementation of the excessive deficit procedure (Council Regulation (EC) No. 1467/97). These two regulations are accompanied by a European Council resolution that gives guidance to the Commission, the Council, and participating member states.

[14]The Council may extend the adjustment period under unspecified special circumstances.

[15]The deposits could amount to between 0.2 percent and 0.5 percent of GDP, depending on the size of the deficit.

[16]On issues pertaining to monetary and exchange rate policies of the ECB, or the application of sanctions under the SGP, non participating member states do not vote.

ECOFIN Council is expected to collaborate with the ECB while respecting its full independence and autonomy.[17]

Is the subsidiarity principle preventing centralization?

The subsidiarity principle does not necessarily imply that policies must be decentralized. In fact, the presumption that policies should be carried at the most decentralized level can be invalidated and overturned either by the failure of decentralization (when "*the objectives... cannot be sufficiently achieved*"), or by a political decision giving *exclusive competencies* to the EU for certain policies. Indeed, the wording of the principle is still not explicit about the definition of *exclusive competencies*. Although the Commission's interpretation refers to the four freedoms (movement of goods, capital, services, and people), ample room for interpretation remains (CEPR, 1993), despite some clarifications in the Treaty of Amsterdam. Therefore, looking ahead, if "European sentiments" and economic integration—spurred by monetary unification—were to generate new demands for central intervention, the subsidiarity principle would likely become less and less relevant.[18]

What happened to tax harmonization?

Under a common currency, tax competition is likely to increase for at least two reasons. First, tax-inclusive prices would become more transparent. Second, with the loss of the monetary and exchange rate instruments, the role of tax policy in attracting business and enhancing competitiveness would become prominent. Therefore, a stronger role for tax coordination and harmonization would be needed to prevent an erosion of the tax base that could lead to fiscal imbalances. Although tax competition may have positive effects in restraining public expenditure, it has become increasingly evident that excessive competition could lead to harmful tax practices. These could, in turn, lead to lower revenue or change the structure of tax systems in directions not always desired by member states. For example, tax competition is already shifting the tax burden from mobile to immobile bases, and reducing the

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[17]The European Council, meeting in Luxembourg on December 12–13, 1997, adopted a resolution on economic policy coordination that would complete preparations for the third stage of EMU. In particular, Article 44 of the Presidency Conclusions restated that the ECOFIN Council would be the center for the coordination of the member states' economic policies, and Article 47 acknowledged that a fruitful dialogue between the Council and the ECB, respecting the independence of the ECB, would be an important factor in the proper functioning of EMU.

[18]It may be noted that countries, such as Germany and Switzerland, that are applying domestically—either formally or informally—the subsidiarity principle, have not been prevented from transferring increasing legislative and economic powers to the central government.

progressivity of tax systems. This being the case, harmful tax competition could seriously undermine the capacity of member states to conduct independent fiscal policy.

Although efforts at harmonizing the European tax systems have fallen short of initial ambitions, a new wave of initiatives has recently revamped the process. In the EU, harmonization of indirect taxes, along with the elimination of fiscal frontiers, has seen some progress, although this has not been the case with direct taxes. As a result—and by default—a move toward spontaneous harmonization has prevailed. At the same time, both the EU and the OECD have intensified their efforts to promote harmonization, the former by adopting a code of conduct for business taxation, the latter by adopting guidelines for dealing with harmful preferential tax regimes (Box 6).

Will there be any EU-wide public goods?

With the establishment of a monetary union, the spatial characteristics of public goods are bound to change. Indeed, as economic integration proceeds and member states' feelings of unity within the euro area grow, spatial incidence—actual or perceived—of public goods may widen, preferences may become more uniform, and thus new European public goods may emerge. Their provision would have to be either centralized or, more appropriately, closely coordinated, regulated, or supported by financial transfers (European Commission, 1993). Defense, security, foreign policy, environmental policy, higher education, research and technology, transportation, telecommunications, and energy are among the goods and services that have already emerged as European public goods (CEPR, 1993), and could increasingly be subject to EU-wide policies. Several observers argue, however, that most public goods would remain regional in nature. If this is the case, their provision would be better addressed bilaterally rather than by a central level intervention (Costello, 1993a; von Hagen, 1993). The role for the EU budget in this regard would then be limited to financing a few clearly identified European public goods.

Are the European structural funds sufficient?

As described in the previous section, the EU budget performs some interregional redistribution mainly through its structural funds, whereas interpersonal redistribution and social security are left to member states. Redistribution by the EU is such that in 1996, three countries (Greece, Portugal, and Ireland) received 4½ times more than they contributed whereas Germany and the Netherlands received only half of what they contributed (see Figure 2). However, given the small size of the EU budget, this produced a rather modest redistributive effect compared to the impact of the federal budget in Canada, Germany, or the United States. In terms of reduction in the differential of national per capita income to the national European average, the redistributive effect in the EU is estimated at between 0.5 percent (Sala-I-Martin and Sachs, 1992) and 3 percent (Bayoumi and Masson, 1995). In contrast, the federal budget provides a redistributive effect estimated between 19 percent and

Box 6. Tax Competition in the OECD and in the EU

Tax competition between countries has been increasing along with the globalization of economies, the rising mobility of factors of production, and the development of financial innovations and information technology (Tanzi, 1996). Tax competition is identified by granting preferential tax regimes on easily transportable commodities, inducing cross-border shopping; tax incentives and tax holidays; transfer pricing practices by multinational companies; and proliferation of tax havens.

Tax competition could be beneficial by lowering both tax rates and public expenditure. But it may also constrain governments in their ability to design their tax systems and hence produce undesirable effects (OECD, 1998). Tax competition can turn into harmful tax practices if it involves measures that are globally damaging or that "poach" the tax base of other countries. In particular, domestic preferential tax regimes have international spillover effects, as they hamper other countries' ability to choose their optimal tax regime, and can lead to the choice of tax instruments that are less efficient or more expensive as to administration and compliance. They may also induce a global misallocation of resources, if for example, location decisions by enterprises are made on the basis of temporary tax considerations rather than genuine economic factors. Finally, preferential tax regimes can create avoidance and evasion opportunities in other countries. A common concern should be to refrain from harmful tax practices so as to avoid a "rush to the bottom" of tax systems, which would prevent governments from sustaining desirable tax policies and financing necessary expenditures.

To tackle harmful tax competition in the OECD, Ministers adopted in April 1998 a set of ***guidelines for dealing with harmful preferential tax regimes*** (Luxembourg and Switzerland abstained from approving them). These guidelines define harmful tax practices as tax havens and preferential tax regimes in member as well as non-member countries and their dependencies, and focus on mobile activities such as financial services. The guidelines encourage countries to refrain from adopting or to eliminate measures constituting harmful tax competition; they address the issue of tax evasion and avoidance, since many forms of harmful tax competition are aimed at taxpayers willing to engage in such practices. One of the main recommendations concerns the *establishment of a Forum to monitor the application of the guidelines*.

In December 1997, the ECOFIN Council agreed on a ***code of conduct for business taxation***. This code of conduct defines potentially harmful tax measures as those providing for a significantly lower effective level of taxation (including zero taxation) than those which generally apply. Harmful measures should in principle be rolled back by end-2002, and members states will refrain from introducing new harmful measures (standstill clause). The ECOFIN Council has also requested the Commission to bring forward a proposal ensuring a minimum effective ***taxation of saving income***. The Council also agreed on the "co-existence model"; each member state would either operate a withholding tax, or provide information on savings income to other member states. In the area of indirect taxation, further coordination of VAT and excise taxes will be required if EU member states intend to drop fiscal controls. The Commission programme, adopted in July 1996, outlines the objectives of the new VAT system, and a timetable for presenting proposals to the Council and the European Parliament up to the end of 1999. The objective is to adopt an origin-based VAT and to agree on a reallocation mechanism for VAT revenue, a more uniform application of VAT rules, and a narrow band for rates, or even a single rate. The adoption of these measures might be slowed by the need for unanimity in the Council of Ministers, but pressure of tax competition in EMU could force governments to reach an agreement.

22 percent in the United States, and between 39 percent and 53 percent in Canada and Germany.[19]

As long as mobility, solidarity, and central intervention remain limited within the EU, redistribution policies appear sufficient. But in the medium to long run, as European integration proceeds, there are reasons to expect that demands for a larger central redistribution function—including social security—may emerge and put pressure on the limited size of the structural funds. First, as mobility increases, the existing decentralized system could be challenged and member states may have to pass on part of their redistribution function to the EU to avoid relocations induced by marked differences in the provision and financing of public goods, as well as differences in social security systems. In this regard, the fact that large migrations of workers could be perceived as politically and socially unacceptable should not be overlooked. Second, as European "sentiments" and solidarity strengthen along with economic integration, a more active redistribution policy may be called for.[20] Third, there may be an increasing role for interregional redistributive policies to compensate losers from EU initiatives. Indeed, the integration process could lead to the imposition of central preferences to member countries or regions, and appropriate compensation may be seen as necessary for redistributive purposes, as well as for allocative efficiency. However, an expanded central redistribution function may face strong resistance, at least in the short term, especially from member states reluctant to finance large and permanent transfers to specific countries or regions. Political consensus is clearly lacking on an EU-wide level. Moreover, the usual counterarguments against redistribution would apply, namely reduced incentives for beneficiaries to adjust, slower prices and wages adjustment, and moral hazard (De Grauwe, 1997, Obstfeld and Peri, 1998).

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[19]Bayoumi and Masson (1995), Duboz and Nicot (1996), Obstfeld and Peri (1998). These studies take into account all financial flows, including personal taxes and transfers, social insurance payments, and grants to states and local governments. The redistributive effect of the federal budget is measured on a long-term basis as the average redistribution over several years (United States 1969–86, Canada 1965–88, Germany 1984–94), as opposed to the short-term stabilizing effect. It is worth noting that this redistributive effect is twice as large in Canada and Germany, where the federal government has more equalizing responsibilities, than in the United States. Still in the latter country, even without an explicit interregional redistribution system, the redistributive effect is quite important, mostly due to the progressive nature of federal taxes and transfers. In a separate study (Costello, 1993b), shows that the EU structural funds, reduce disparities interregional per capita income, by 2.5 percent, whereas the interregional transfers by the federal budget in Germany reduces disparities by 5.2 percent, in terms of Gini index.

[20]EU members, and regions within them, are still characterized by widely different levels of income. In 1997, the 10 most prosperous regions were three times as rich as the poorest ten, and member states' GNP per capita ranged from an index of 46 (Portugal) to 137 (Denmark) and 186 (Luxembourg).

Should macroeconomic stabilization be centralized or decentralized?

In a federation, the federal budget has an automatic stabilizing effect in the event of shocks affecting local economies. In case of a local recession, federal taxes paid by local residents decrease, and federal transfers (both personal and interregional) increase, thus having a countercyclical effect. Several studies suggest that the federal budget in Canada, Germany, and the United States reduces respectively 17 percent, 48 percent, and 30 percent of the short-term fluctuations of subcentral per capita income.[21] Some authors, observing such stabilizing effect, have inferred that a separate EMU budget would be necessary to achieve the same effects in case of asymmetric shocks. Others, however, have pointed out that subcentral fiscal policies could very well handle these shocks by running temporary deficits and surpluses (von Hagen, 1993). Estimates suggest that fiscal policies run independently by EU member states yield a stabilizing effect of about 31 percent, which is comparable to, if not greater than, that of federal governments in Canada and the United States (Bayoumi and Masson, 1995).

While centralized and decentralized stabilization policies seem both possible, their effectiveness may differ widely. In a decentralized framework, subcentral governments facing negative shocks have to increase their debt temporarily. If taxpayers are at least partially Ricardian, the higher debt and the higher future taxes needed to finance it will dampen stabilization. This effect could be offset, however, to the extent that the costs of higher debt will be borne in part by other EMU member states. In a centralized, EU-wide, system of transfers among member states facing opposite shocks, assuming that these shocks are equally likely to affect any country, stabilization policy could be more effective (Masson, 1996, Muet, 1995). Recent empirical work on Canada suggests that central stabilizers, which create no future tax liability, are at least twice as effective as provincial stabilizers (Bayoumi and Masson, 1998). An insurance-type transfer mechanism would therefore not only benefit member states facing negative shocks, in a way analogous to that existing in federations, it may also increase the cost-effectiveness of stabilization policy. A model proposed by Italiener and Vanheukelen (1993) would achieve the same effect as the federal budget in the United States, while costing only 0.2 percent of total European GDP.[22] However, it has also been argued recently that the potential benefits from such an insurance mechanism decrease over time as economic cycles become more closely linked in the EU (Fatás, 1998).

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[21]Bayoumi and Masson (1995), Duboz and Nicot (1996), Fatás (1998), Obstfeld and Peri (1998), Sala-I-Martin and Sachs (1992), von Hagen (1992). For the United States, the estimates are controversial and vary between 10 percent, 30 percent, and 40 percent.

[22]The mechanism operates on the basis of changes in unemployment in each member country relative to the EU average; if positive, the country receives a payment. The scheme could be financed by increasing the size of the EU budget.

Is the SGP flexible enough to ensure macroeconomic stabilization?

Several observers have argued that the SGP may be redundant if not a "nuisance," for primarily three reasons (von Hagen and Eichengreen, 1996, Eichengreen and Wyplosz, 1998). First, since market discipline imposes a limit on each member state's fiscal deficit, there would be no need for formal constraints. Second, the Maastricht Treaty already contains a no-bailout rule since the ECB is prohibited from purchasing public debt directly from the issuer (Article 104 of the Treaty, complemented by Article 21 of the Protocol on the ESCB). Third, the SGP would tend to suppress the symptoms of an excess deficit bias without eliminating the cause which may be deeply rooted in countries' institutional arrangements, such as their budget procedures.

To the extent that member states maintain balanced budgets over the medium term, there does however seem to be some agreement that the SGP would allow automatic stabilizers to operate (Buti et al., 1997). According to IMF estimates, the deficit reference value is expected to be sufficiently flexible that individual countries can accommodate the effects of automatic stabilizers for variations of up to 5 percent around potential GDP.[23] In addition, economic and monetary integration should increase the positive correlation of output fluctuations among EMU members, and therefore reduce the likelihood and importance of asymmetric shocks (Begg, 1997).[24] But to the extent that countries will enter EMU at the upper limit of the SGP, there may be initially little room for the normal operation of automatic stabilizers, which could lead to weaker fiscal stabilization and greater output volatility than has been the historical norm (Bayoumi and Eichengreen, 1995). Such outcome could be aggravated as member states see the range of discretionary policy tools—notably tax policy— reduced by EU integration (Bayoumi and Masson, 1995). Under such circumstances, there may be calls for stabilization through the EU budget, which could result in large and lasting transfers (von Hagen and Eichengreen, 1996).

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[23]A 1 percent shortfall of actual output from potential worsens the fiscal balance by 0.6 percent of GDP, on average; from a structural balance position, a country could then accommodate an output gap of 5 percent without exceeding the 3 percent deficit reference value (IMF, 1997, p. 58).

[24]Regarding the SGP's underlying rule—a cyclically-adjusted balanced budget—it may, on one hand, not be overly ambitious for EMU members given their high debt levels and the demographic challenges that lie ahead; however, on the other hand, as it would lead to a decline of the debt-to-GDP ratio, it may be unnecessarily tight for countries already well below the 60 percent level (Begg, 1997).

What happened to automatic stabilizers ?

The preceding discussion suggests two questions that have been somewhat neglected in recent debates as well in the academic literature.[25] First, is the current size of automatic stabilizers adequate? Second, could member states face tensions between targeting the fiscal position and stabilizing output?

First, the magnitude of traditional automatic stabilizers is likely to have diminished. Tax reforms have in general flattened tax systems by cutting marginal rates. Moreover, increased reliance on consumption relative to income as tax base, implying a decline in the role of revenues collected from the corporate sector, has further reduced the responsiveness of the tax base to output fluctuations. The share of cyclically sensitive spending may also have been reduced by improved targeting of social assistance programs and reduced replacement ratios for pensions and unemployment benefits.[26]

Other factors may also have led to a reduction in automatic stabilizers. Despite relatively expansionary fiscal policies in the EU during the early 1990s, partially Ricardian consumers may have anticipated higher taxes, with the third stage of EMU approaching, and consequently may have increased their savings. Financial markets have responded to high deficits by charging risk premiums. Both factors may have contributed to reduce the macroeconomic effects of fiscal policy through the emergence of non-Keynesian effects on demand (see Alesina and Perotti, 1997, McDermott and Wescott, 1996). In addition, growing international trade has increased the EU members' economic openness, thus reducing the effectiveness of domestic stabilizers.

Second, under the SGP, member states could face tensions between targeting the fiscal position and stabilizing output. In general, a country seeking to stabilize output would welcome cyclical sensitivity in its budget, while a country pursuing a fiscal deficit target would be helped by a budget that is relatively insensitive to output changes. Thus, to pursue output stabilization requires strong fiscal stabilizers, which in turn imply an unstable fiscal position. In preparing for their entry in EMU, participating member states have focused more on reducing the cyclical sensitivity of their fiscal position, and keeping their deficit within the

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[25]It is interesting to note that some recent textbooks on public finance hardly mention the macroeconomic stabilization function of the budget (see, for instance, Rosen in 1995). By contrast, older textbooks (such as the 1973 edition of Musgrave and Musgrave) devote whole chapters to this subject.

[26]The most important factor for fiscal stabilizers remains the size of tax revenues in the economy: countries with low taxes relative to GDP (United States, Japan, United Kingdom, and Australia) have low automatic stabilizers from the revenue side, while those with a high tax share (Denmark, Netherlands, Norway, and Sweden) have higher stabilizers (OECD, 1993).

Maastricht criteria despite output fluctuations, rather than letting automatic stabilizers fully operate. Under the SGP, they may have to switch objectives and let their fiscal position fluctuate.

Will the envisaged policy coordination framework be effective?

While the SGP provides a clear and strict framework for fiscal convergence and stability, it appears relatively weak as to fiscal policy coordination. The need to coordinate discretionary fiscal policies within EMU may arise in a number of situations, such as a risk of overheating, a severe EU-wide recession, and a supply shock. Under these scenarios, the envisaged policy response is that the ECB would carry out a EU-wide stabilization policy through monetary policy.[27] But if inflation is already high, this could mean giving monetary policy conflicting objectives—since it has to focus primarily on price stability. Discretionary fiscal policy measures may then become necessary. However, decentralized stabilization policies may entail free-riding behavior so that member states may not be willing to provide necessary fiscal stimulus or restraint, because a large part of the benefit would accrue to other countries, or because their fiscal position may already satisfy their domestic needs.

In the context of multilateral surveillance, the ECOFIN Council is not equipped with the necessary instruments to handle the policy coordination function. It can only agree on broad economic policy guidelines, but does not have the authority to enforce participation in policy coordination. Therefore, coordination relies exclusively on exchange of information, publicity, and peer pressure (European Commission, 1997). The SGP's enforcement relies on the possibility of sanctions—acting as a deterrent—against noncompliant member states. But the imposition of sanctions does not substitute for the lack of appropriate policy coordination.

There may also be some doubts on the effectiveness of the SGP's procedures in tense situations. It is likely that member states would strive to avoid excessive deficits prior to being subject to sanctions, even with "creative accounting" or "accounting fudges" if necessary.[28] Furthermore, imposing sanctions and fines on a country facing genuine economic difficulties, which would have already been penalized by market mechanisms by way of higher interest rates, could only worsen its situation and induce negative reputation effects. Finally, sanctions are not automatic, but require qualified majority approval among participating members. As a result, decisions of this sort will certainly be highly politicized, thus undermining the accountability and transparency of the SGP's enforcement.

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[27]"In case of euro areawide disturbances (symmetric shocks) the main stabilization function will be performed by the ECB subject to the paramount goal of price stability, and the main role for fiscal policies would be to allow automatic stabilizers to operate" (European Commission, 1997, p. 116).

[28]On recent experiences, see for instance Dafflon and Rossi (1998).

Is there a role for a central fiscal authority?

The ECB has been vested with a high degree of independence, which is essential to the credibility of EMU. However, credibility risks being undermined if the framework designed to coordinate fiscal policies is perceived to be weak. First, the ECOFIN Council coordinates fiscal policies for *all* EU member states and not strictly those of the euro area. Second, the ECOFIN Council does not have the necessary instruments to enforce its decisions on coordination, as the SGP imposes limits but sets no binding rules for member states that stay within these limits. Third, contrary to the ECB, the existing institutions are perceived as highly politicized, to the extent that there is some skepticism on the ability and willingness to strictly enforce the sanctions envisaged by the SGP. If transitional frictions were to arise, the credibility of EMU may be severely challenged right at the onset.[29] It is no surprise, therefore, that an increasing number of observers are beginning to realize that the current institutional framework of EMU may not be "carved in stone,"[30] and that the SGP may need to be "either amended or ignored."[31]

To address these growing concerns, the European Council has agreed that finance ministers of the countries participating in the euro area could meet *informally*—the so-called Euro-11—to discuss issues connected with their specific responsibilities for the single currency, if necessary with the Commission and the ECB. But although the promoters of this new grouping would like to see it grow in importance and become the political counterweight to the independent ECB for economic policymaking, it remains institutionally as weak as—if not weaker than—the ECOFIN Council as regards fiscal policy coordination. It therefore seems unlikely that Euro-11 can act as a central fiscal authority for EMU, prefiguring an "economic government of Europe."[32]

Nevertheless, to enhance policy coordination in the euro area, and to address possible economic turbulence, alternatives to the current framework exist for macroeconomic stabilization, although they seem unlikely to be implemented in the immediate future. For example, a specific central fiscal authority could be created which would manage a stabilizing transfer system by pooling funds from member states, in case the SGP turned out to be too tight. Such an authority could also be endowed with a "war chest" to be used for discretionary expansionary policies in member states, along with enhanced coordination of

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[29]The uniform monetary policy for the euro area could, in the short term, imply an expansionary monetary stance in some countries and a contractionary stance in others. This could lead to temporary tensions until the necessary adjustments take place.

[30]"The ECB Must Manage the Mix," *Financial Times*, January 13, 1998.

[31]"A Survey of EMU," *The Economist*, April 11, 1998.

[32]"The Great Experiment," Guide to EMU, *Financial Times*, September 23, 1998.

policies, that could be financed by an increase of the EU's share in the current revenue-sharing arrangement, for example through an increase of VAT revenue or the GNP resource.[33] Alternatively, it could be organized in a manner similar to the IMF, with member states contributing a quota to be used in case of adverse developments and subject to conditionality.

IV. Concluding Remarks

Unlike other federations, EMU will not have a central fiscal authority. According to many observers, the absence of a central fiscal function should not pose major problems. However, one may argue that the fiscal framework for EMU does not contain clear-cut procedures for achieving an adequate degree of policy coordination.

The purpose of this paper was to discuss whether the envisaged assignment of fiscal functions within EMU would ensure a proper functioning of fiscal policy under a single currency. Although policy coordination in other federations has been achieved by effectively centralizing most of the basic fiscal policy functions—most notably macroeconomic stabilization—the envisaged EMU fiscal policy framework appears quite different. In particular, the SGP is designed to balance the opposite needs of coordinating policies while maintaining the independence of sovereign states.

This paper has argued that, although not a necessity, a more active central role could be justified on the grounds of allocative efficiency, redistribution, and stabilization. As the spatial incidence of public goods widens and new externalities emerge along with economic and monetary integration, a central intervention may be superior to the existing national or bilateral intervention. Preventing the likely negative effects of excessive tax competition would certainly require a more active role at the center. In the longer run, as mobility increases with the completion of the single market and the deepening of the integration process, the current limited scope of central redistribution policies may have to be expanded. Because of free-riding behavior, decentralized fiscal policies may not provide the degree of macroeconomic stabilization required by the euro area. A centralized approach with stronger policy coordination would then be desirable. However, as desirable as creating a central fiscal authority and providing it with a larger budget may be, it may not be feasible in the short-term because of the absence of a political agreement and the delays inherent to EU's institutional process.

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[33]In the short term, member states would certainly oppose such an increase as they would be competing with the EU for the same tax base. Another possibility would be to assign one or several specific tax bases to the EU. In this case, a possible candidate could be the field of eco-taxation; these taxes are not much developed at the national level and their centralization could be optimal, since environmental externalities generally affect the whole EU area and tax competition may prevent any individual country from adopting an eco-tax (Spahn, 1993).

In the short term, enhanced coordination may be able to address most of the above-mentioned issues in a satisfactory way. But while EMU is launched in a favorable economic upturn, the business cycle may change direction in the medium-term and lead to economic difficulties. These may reveal that the SGP does not achieve as much cohesion as intended, and may require either more flexibility in its procedures or a more strongly coordinated policy response. In such context, a central fiscal authority, endowed with some funds, may prove an effective instrument for macroeconomic stabilization. And while the current flexible framework may be sufficient in the short- and medium term, it may have to be strengthened progressively in the long run to address the demands and the needs of fiscal policy regarding allocation, redistribution, and stabilization, as both integration proceeds and a sense of European unity grows.

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