

**PREREQUISITES OF A SUSTAINABLE EUROPEAN UNION:
A DISCUSSION ON CENTRALIZATION, DECENTRALIZATION, EUROPEAN FISCAL
EQUALIZATION SCHEME AND ECONOMIC INSTITUTIONS**

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ABSTRACT

There is no doubt that the European Union currently is in a deep political, institutional and economic crisis. Finding solutions for a sustainable European Union means to learn from political, institutional and economic mistakes in the past. Therefore, a substantial and more realistic analysis is required taken into account the real frameworks, interests and behaviors of European actors to identify answers for current problems within the multilevel system of the European Union.

The present paper focusses on three aspects. After an introduction, section 2 discusses the supposed trade-off between centralization and decentralization in a multilevel system. Following Apolte (2004), the European Union even more than before needs an appropriate assignment of political and economic power that includes centralized legislative power as well as decentralized legislative power in contrast to the "Executive Federalism System" in the present European Union system. Section 3 argues that a European Union with economic strong and economic weak member states needs a European fiscal equalization scheme. Economic justification is based on the institutional setting of the European Union with European wide standard settings and partly inabilities of some member states to achieve minimum standards. Thereby, the neo-classical thesis of economic incentives will be examined and rejected. However, while other incentive aspects as well as focusing on the demand side in contrast to the supply-orientated economic literature are issues of section 3, a number of arguments lead to the requirement for European wide fiscal equalization inspired by the goals of the German fiscal equalization scheme. Finally, section 4 gives a discussion on useful economic institutions in for sustainability of the European Union. In other words, the last part focusses on an institutional-economic framework taken into account the foundations of a rather Keynesian argumentation of demand-orientated financial policy in contrast to the neo-classical based New Institutional Economics (NIE).

The paper concludes that a critical view on centralization and decentralization as well as on the needs of fiscal equalization schemes can help for the construction of a modern European Union to avoid in consequence a harmful divergence and disintegration in the near future.

KEYWORDS: European Union, Fiscal incentives, Fiscal equalization, Multilevel system.

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1. Introduction

With beginning of the global financial crisis in 2007/2008 and the economic effects that are still going on at present, many economic contributions have been provided on the search of solutions for a couple of economic problems within the European Union. But, although some problems still not described appropriately, we could observe political activities in many fields in the past few years. In light of current macroeconomic data, e.g. economic growth, unemployment rates, inflation rate, private investments, no single problem in the European Union has been solved comprehensively until today.

Because of non-existent but required instruments to face the challenges in the European Union, ad-hoc activities of the European institutions as well as the Governments of the European member states have rather frozen than improve the economic situation within the European Union. Otherwise, the current situation is a complex structure of some problems in several regions of the European Union. However, the ad-hoc activities have not solved problems. Extremely high unemployment rates in some member states (Greece, Spain) and above average unemployment rates in Italy and Portugal on the one hand and historic low unemployment rates in Malta, Czech Republic as well as Germany describe a wide range of developments on labor markets within the EU. While, for example, the general government deficit in Germany currently is in surplus many EU member states show immense budget deficits. Expenditure cuts in some EU member states are following which lead damage the economic development. Of course, expenditure cuts in some cases are an appropriate way to reduce allocative inefficiencies. Otherwise, the positive effects of expenditure cuts are only appearing long-term while short-term effects usually negative for the economy and for the people in particular. For instance, Censolo and Colombo (2016) present a study on the impact of the crisis on fiscal convergence in the EU and show results that indicate more divergence.

The „successes“ of some activities in recent years, e.g. “Six Pack”, “Fiscal Compact” and “Two Pack” (cf. Laffan and Schlosser 2016) are moderate. The European Fiscal Compact¹ as political consequence of the perception that the EU crisis is a public debt crisis (Heise 2012) does not work and cannot work properly. For example, in a period of economic weakness the Fiscal Compact miss the target “to promote conditions for stronger economic growth in the European Union and, to that end, to develop ever-closer coordination of economic policies within

¹ Treaty on Stability, Coordination and Governance in the Economic and Monetary Union of March 2, 2012.

the euro area". The EU sponsored rescue packages for distressed EU member states have not encouraged the recipient countries and the economies respectively.

Moreover, the financial policy in the European Union has let the European Central Bank down. The result is a historic low interest rate level with negative consequences for many fields of economic activities, e.g. retail banking and pensions insurance while the public sector, the investment banking and wealthy individuals benefit. The consequence is an increasing social inequality while the monetary policy of the ECB does not drive the economic growth in the EU. There is a lack of fiscal policy.

For some time, there are requests for further development of the European integration. Not only Heise (2012) discuss a "European Economic Government" to solve economic problems of the EU. While most authors cannot describe what a European Economic Government should be in reality with consequences for sovereignty and institutions, opponents of a more integrated EU talk about a "European Superstate" and reject the discussion on more centralization. Based on an alleged tense relationship where one have to decide between centralization and decentralization, more centralization is rejected by proponents of more decentralization. Thereby, decentralization should be combined with more possibilities of intervention for the EU's member states on EU wide policies. This can be explained with "Individualism-Decentralism-Analogy" (Apolte 2004; 1999) because of the suggestive power within political debates (Apolte 2004: 272).

A cool-headed, unequivocal and prudent discussion on the sustainable structure of a modern European Union must be a consequence of the current construct being dysfunctional.

Consumer sovereignty, citizen sovereignty and some misunderstandings

The liberal principle is fulfilled by free and functioning markets where free individuals arrange and maximize individual benefit without coordination with third parties. Economic freedom of action allows differing between at least two alternatives, subject to the condition that the other market side provides alternatives in the case of functioning markets. Individuals are consumers and decide on their consumption autonomously. Then, it can be assumed that given comprehensive information any decision is suitable to satisfy individuals' need. In this case, collective decisions are not need because the individual can solve own problems autonomously (individualism principle). Individual freedom is what corresponds to the liberal principle. There is no plausible reason to believe that individual freedom is not used to make

individuals' life better. Quite the contrary, individual economic freedom should lead to good solutions for individual's needs.

Otherwise, economic research show several reasons for market imperfections and the transmission of individual scope of decisions and actions to collective entities. For example, pure public goods cannot be provided by private-individual decisions because of high externalities and free-rider problems. Instead, public-collective decisions are needed to provide pure public goods that meet citizens' preferences. Note that members of society separate the area of private-individual decisions from the area of public-collective decisions. Among economic criteria there are non-economic criteria that are can used to define the area of public-collective decisions. A society can have certain values and social objectives which is why not only economic efficiency is important for the distinction between private-individual and public-collective decisions (cf. Haucap 2007).

Following Apolte (2004: 275), this serves to clarify the relation of individuals to state. Citizen sovereignty can serve where interest of sovereigns can be considered in the area of public-collective decisions at the best. In other words, a public community in terms of „Territorial and intergenerational association“² (Vanberg 2009: 294) where the democratic community, following Vanberg, is a cooperative in a generic and original sense, equal citizens decide on common interest in a self-government organization (Vanberg 2009: 294). In consequence, the quality of democratic communities can be measured by structures that guarantees political-administrative decisions oriented towards the common interests of the citizens. A least it depends from the point of view whether the area of private-individual decisions or the area of public-collective decisions is the residuum after distinction of each parts.

Decentralism principle and one prominent fallacy

In political and economic discussions, the decentralism principle frequently plays the role of the guarantee for ensuring the principle of citizen sovereignty. The smaller a jurisdiction, the better citizens' preferences can be satisfied. The advocates of the decentralism principle believe that extremely small jurisdictions can be treated almost like an individual (Apolte 2004:

² In the original text, Vanberg calls it “Territorial- und Generationenverband“.

273). That is the basic for the so-called “Individualism-Decentralism-Analogy”³ (Apolte 2004). But, from an economic point of view this is a fallacy. It does not matter how small or large a jurisdiction is. Any collective is and remains a collective. The problems of collectives (costs in terms of political frustration, possibilities for minorities to dominate majorities, rational ignorance) exist in large as well as small jurisdictions. It makes little difference whether an individual is governed by a majority in a jurisdiction of 1.000.000 individuals or by a majority in a jurisdiction with 100 individuals.

Furthermore, a false interpreted decentralization principle can lead to a structure where very small jurisdictions can get a power to exercise significant influence on decisions of the central level in a multilevel system. In sum, it means that decentralization is not the opposite of centralization and the participation of small jurisdictions on decisions at higher levels is not a decentralization in the economic sense. Unfortunately, for quite some time many voices tend to ask for a “new” European system with strong (legislative) power of the Member states. However, this seems to be a discussion on a future confederal state as conception for the European Union.

Consequences for Multilevel systems

Based on the so-called “Basic Theory” a citizen can share the sovereignty vertically and legitimate several level of government within a hierarchic multilevel system to clarify common interest. Some tasks have limited ranges, some task have high ranges. This justifies very small jurisdictions (e.g. municipalities) as well as large jurisdictions (e.g. federal level). Therefore, decentral decision-making units and central decision-making units can exist simultaneously. However, this is an accurate description of the term “decentralization” if small jurisdictions clarify their affairs in the local area without interventions from higher levels of government while large jurisdictions fulfill their tasks in the central area. Note that any level of government derives the legitimization from the sovereign, the “basic”. In contrast, the „Pyramide Theory“ assumes a hierarchy where small collectives are legitimized by the sovereign. In a bottom-up process, any higher level of government derives the legitimization from the lower level of government. In this case the collective on the lower level can only legitimize the jurisdiction

³ Apolte calls it „Individualismus-Dezentralismus-Analogie“ in the original text.

above in whole. This is the alleged “Individualism-Decentralism-Analogy“ where a collective has only one voice to legitimize jurisdictions on higher levels.

In comparison of the basic theory and the pyramide theory there are many reasons to follow the basic theory to set a specific vertical structure in a multilevel system. Following the basic theory legitimized agents on the local level decide for the local principal exclusively while agents on the federal level decide for the federal principal. In contrast, following the pyramide theory in the case of two level of government agents of the federal principals decide on the federal level but local jurisdictions can influence federal decisions. It results in a mixture of competences.

In Germany, the sovereign elect member of the German Bundestag to solve problems on the federal level. However, the German Laender, represented exclusive by the Laender governments, have rights to co-decisions in many fields of politics. “Executive Federalism” seems to be a form of decentralization because of the participation of jurisdictions at lower levels to decisions on higher levels. In fact, these systems are “Decentralization fakes” where appearances are deceptive. Of course, one single jurisdiction has a share in federal decisions via the Bundesrat, but any jurisdiction depends from the majority. Moreover, a further question is: If a federal parliament is responsible to solve federal problems that affect nearly every citizen of the federation because of the specific character of the problem in order to provide federal wide goods,⁴ why should agents from lower level who legitimized in order to provide regional goods participate on federal decisions? Is it possible that the “federal citizen” knows his preferences and interest and can clearly articulate to the agents at the federal level, but the “regional citizen” mistrusted this alter ego as federal citizen, that is why the regional citizen instructs its regional government as “corrective”.

Of course, in a vertical hierarchic structured multilevel system, interdependencies can not avoided. This is subject of “Multilevel fiscal governance” as a subsidiary function in cases where only centralized or decentralized decisions are not sufficient to solve problems adequate. But, this is not a justification for a general competence of jurisdictions to participate on decisions on higher levels of government.

⁴ Otherwise, in the opposite case why the federal jurisdiction should be legitimized for solving problems that affect only parts of the federation? In this case true decentralization would be the appropriate answer.

Institutional Reform of the European Union in General

Currently the European Union is still designed according to the principle of the “Pyramide Theory”. Furthermore, a misunderstood decentralization actually leads to many problems for the present structure of decision-making within the European Union. The two-tier legitimization structure of the European Union (Franzius 2013), based on article 10 of the Treaty of European Union, in conjunction with the de facto “Executive Federalism” of the European Union where the Council represents the governments of the EU’s member states and is one of the most important institution of the EU legislature.

The arguments presented in the part above show the importance for a balance of centralization and decentralization within a multilevel system. To avoid efficiency losses political-administrative decision-making units need distinct scopes for action and thereby a clear vertical assignment of public tasks and competences to fulfill the assigned functions and public tasks.

Real decentralism means much less structures in terms of executive federalism but more divided and appropriate assigned competences to different levels of government. This includes a strong central level in the EU with competences for solving EU-wide challenges.

Nevertheless, divided and shared competences in terms of “Multilevel Fiscal Governance” can be the third structure among centralization and decentralization in terms of a subsidiary function caused on the knowledge that some policies generate vertical as well as horizontal effects that have to clarify through an appropriate governance mode mixture.

Institutional Reform of the European Union in Particular

One rather neglected or else rejected an EU-wide fiscal equalization scheme in response to important challenges for a sustainable EU. At a first glance, some arguments may be envisaged to reject any proposal for an implementation of an EU-wide fiscal equalization scheme. A prominent argument is negative incentives of transfers. Political-administrative decision-makers in donor countries and in recipient countries may reduce the activities to drive economic growth because of the compensating effect of fiscal transfer.

There is no question that incentives for political-administrative decision-makers are have to take into account. But, what are the relevant incentives? If we assume self-interest orientated political-administrative decision-makers, we have to identify the influence factors that are

responsible for the limitation of decision-making scope. Political-administrative decision-makers are guided by their self-interest and try to maximize votes. To achieve this goal, political-administrative decision-makers directly provide political programs to satisfy specific groups of voters. Thereby, revenue maximizing is a helpful tool to support vote maximizing.

The argument of most economic contributions is as follows: The higher the fiscal transfers as consequence of a strong compensating fiscal equalization scheme the lower is the willingness of political-administrative decision-makers to drive economic growth associated with job creating and raise in public revenues. The fiscal incentive thesis implies the focus on public revenues and suggests a reduction of public economic activities if revenue shortfalls as well as additional revenues will be compensated by equalizing transfers. But note that this argument needs the focus on public revenues. A vote maximizing government is primarily interested in attracting firms and job creating. Both, jobs and specific political programs funded by the given public budget ensure votes at the next election. What influence can have additional public revenues for regional decisions?

Additionally, some further arguments speak against the assumed mode of action of the fiscal incentive thesis in the fragmented public sector of a multilevel system. First, positive developments of economic growth and jobs lead to decreasing expenditures. For instance, increasing employment reduces cost of unemployment (unemployment benefits, social costs of unemployment). Some public provided goods exhibit economies of scale that lower average cost in per-capita terms if jurisdictions can attract additional firms and residents. Second, because of real existent federal legislative and specific fiscal arrangements outcomes of economic development must not correspond locally with the location of activity. For instance, in Germany within the horizontal fiscal equalization among the German *Laender* the manner and scope of allotment the of the land shares of Corporation tax, Wages tax and Withholding tax on income from capital is regulated such as the revenues shall not accrue to the individual *Länder* to the extent that such taxes are collected by finance authorities within their respective territories. In order that the allocation of these taxes does not follow the principle of “local revenue” for some reasons. A neglected aspect is the allocation of the assessed income tax which is beard by self-employed person where the location of work and the location of residence can differ. Another economic problem for non-sufficient revenue allotment can be land rent absorption. At least, the problems of tax havens have to take into account. Third, a general question is how strong can be the impact of economic policy on regional economic development. Blume and Döring (2009) have pointed out the impact of regional economic policy to explain differences in regional economic development in Germany. The conclusion

was a rather weak impact which is taken into account if incentives for regional political-administrative decision-makers are discussed.

Fiscal equalization schemes can be justified for several reasons:

- Interregional internalization of external effects
- Interregional fiscal distribution
- Interregional stabilization
- Payment of risk premium for federal agreements

Fiscal equalization to internalize external effects within a multilevel system is the traditional view on fiscal federalism. Many authors of the so-called “First Generation of Fiscal Federalism” (Oates 2005; Weingast 2009) have mentioned the function of internalization within a multilevel system because of inefficiencies in local provision resulting from the failure to internalize interjurisdictional externalities” (Oates 2005: 356). However, the theory of grants helps to understand possible problems of transfer systems to achieve efficiency in the case of horizontal and vertical spillover.

The next justification for fiscal equalization are challenges within a multilevel system to enable jurisdictions to provide public goods on federal wide minimum levels. In systems of “Administrative Federalism” the political-administrative decision maker⁵ could set minimum standards on lower level which have to take into account in the provision of public provided goods on the lower level (cf. Seitz 2008). If a jurisdiction at a lower level does not have sufficient fiscal capacity transfers to enable to provide public goods on federal wide harmonized minimum standard level can be justified. Otherwise, regional provision of certain public provided goods below the federal wide harmonized minimum standard level can lead to external effects (Advisory Council of the German Federal Ministry of Finance 2005).

In past years, some contributions shed a light on positive effects of more fiscal integration in the EU or fiscal equalization respectively. For instance, Dolls et al. (2013) have analyzed two different systems (“key scenarios”) of fiscal integration and find moderate gains of stabilization of a joint tax and transfer system within 17 Euro area member states. The study builds on Bargain et al. (2013) where most authors are identically.

⁵ Please note that a citizen in the function as sovereign is a „hybrid“. This means citizens are local citizens, state citizens and federal citizens (in a three-tier multilevel system) simultaneously. Thus, political-administrative decision-maker have to consider the preference structure of a multi-divided individual.

Not least, from an institutional economic point of view any contract is imperfect. Taken into account that federal agreements need actors on several levels of government and these actors can have different forecasts with respect to certainty and risks of the agreement's results (Döring 1999).

Additionally, we know that under specific circumstances tax competition can lead to a "race-to-the bottom" that means autonomous political-administrative decision makers apply a tax policy where tax rates on mobile tax bases fall to an inefficient low level. The explanation is political-administrative decision-makers consider the effects in the own jurisdiction but not the overall effects. Regional decision-makers take not into account fiscal externalities caused by regional tax policy. Otherwise, the regional decision-maker conjectures a marginal rate of transformation between public goods and private goods less than 1 (e.g. Wellisch 2004: 63 ff.). In other words: The regional decision-maker focusses on the tax burden within the own jurisdiction. Increasing tax rates lead to a shift from the private sector to the public sector. Additionally, a tax on a mobile tax base lead to an outflow of tax base. To avoid this, any decision-maker in an interregional tax competition set the tax rate on a mobile base inefficient too low. However, from the federal view the outflow is not a cost component because other jurisdictions within the multilevel system can expect mobile tax base inflows. Nevertheless, the result is the inefficient provision of public goods in regions because of too low tax rates.

In recent years, some contributions have shown the welfare-enhancing effect of fiscal equalization schemes. Buettner (2006a; 2006b) provides evidence from German municipalities and points out the incentive of a higher marginal contribution rate. This corresponds with theoretical contributions of Koethenbuerger (2002) and Bucovetsky and Smart (2006). A recent published study issued by Egger, Koethenbuerger and Smart (2010) presents robust findings for a positive correlation between equalizing transfers and tax rates.

Looking to the European Union, we can see a race to the bottom in tax rates over the last decades. It does not mean a reduction in ability to fund public goods in general because total taxes ratios (in percentage of GDP) rose in many EU member states in the past. But, it can be expected an inefficiency in the provision of public goods. Therefore, among other reasons the European Union should discuss on an EU wide fiscal equalization system.

Conclusion

The paper gives a critical view on centralization and decentralization as well as the needs of fiscal equalization schemes. The European Union has to decide whether the way leads to a confederal system with strong power of the confederal member states or a true federal system with economic and political required assignment of competences. With reference to the argument above, the future European Union should be a federal system with decentralized and centralized competences. The starting point should be recognition that centralization and decentralization is not a contradiction but a useful and helpful overall concept to clarify the vertical allocation of competences with economic arguments. The modern European Union needs both real centralized provision of European wide public goods as well as real decentralized provision of regional and local goods. Therefore, this is compounded by the fact that a modern European union needs a real “European citizen” who can legitimize a real “European parliament” that places orders to a real “European government” for solving European problems.

One prominent problem will be the differences between the European regions and harmful divergences and disintegration. Therefore, a simple European fiscal equalization scheme can help to strengthen the solidarity. The economic discussion presents some arguments for implementation of fiscal equalization in particular from an allocative point of view.

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