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# Quo Vadis Europe?

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# The Theory of Fiscal Federalism: What Does It Mean for Europe?

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## 1. Introduction

At the core of the ongoing political and academic debate on European integration lies a fundamental question: What is the appropriate assignment of policy tasks to different levels of government? According to the principle of subsidiarity, the burden of proof lies on the advocates of centralization. But the appropriate scope and application of the principle of subsidiarity is often debated and debatable (see Begg et al. 1993).

Different member states of the EU, not to speak of different citizens within these states, have different views on the desirable scope and depth of integration. There is disagreement over which areas of policy-making should be transferred to supranational European institutions. There is also disagreement on how much power to give up to European political bodies in those areas. This disagreement is illustrated not only by the different views on the EMU project, but also by widely different views on other prospective areas of integration: defense, social policy, competition policy, antidrug enforcement policy, environmental policy, and others.

This paper asks what economic theory has to say about this normative problem. Our starting point is *traditional* economic theory, which approaches the question of policy assignment from the perspective of social welfare maximization by a Pigovian benevolent planner. This leads naturally to a tradeoff between information and incentives: decentralized decisions typically rely on better knowledge of local preferences and conditions, while centralized decision-making internalizes different forms of externalities. The traditional approach to fiscal federalism, dating back to the seminal work of Oates (1972) and Musgrave (1959), offers a number of important insights on the question of policy assignment.

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We argue that the traditional approach also has important shortcomings, however. Typically it ignores generalized second-best arguments related to incentive constraints on the policy formation process. Decentralization (or centralization) of authority may correct existing distortions in the economy or in the political decision-making mechanism. It can therefore be welfare-enhancing even if it was welfare-deteriorating in the absence of such distortions. A good example is education. The Pigovian approach argues in favor of decentralization of education since cross-border externalities from education are typically not huge. This presumes that education services are provided efficiently. However, university systems in several European countries are notoriously inefficiently organized. European programs that encourage mobility of students and professors foster competition between universities and thus give better incentives to reform inefficient university systems of individual countries.

Moreover, the traditional approach typically abstracts from political decision-making inside government when individuals have different preferences. This may be important, as decentralization or centralization of decision-making authority may affect the coalition formation process and the balance of power between various interest groups, given the specific rules for political decision-making at different levels of authority. For example, the traditional theory argues in favor of centralization of redistributive policies. In practice, however, such a shift would be strongly opposed by many countries and by large fractions of public opinion. National governments oppose net transfers to citizens of other countries and voters of right-wing (left-wing) parties fear that redistributive policies at the European level would be too much to the left (right) compared to policies favored by a majority in their own country.

We will argue that these shortcomings appear systematically when examining task assignment in government. Thus, it will be helpful to adopt a broader *political-economy* approach that addresses the second-best effects of centralization, as well as its effects on coalition formation. This political economy approach is particularly appropriate in the current European situation. Right now, Europe is not a true federation, but a confederate organization: a much looser entity with more diverging interests across individuals and states. The traditional theory of fiscal federalism cannot explain, for example, why there is so much reluctance to adopt a common European defense policy.

The next three sections of the paper are structured according to Musgrave's famous classification into three branches of government. Thus we discuss, in turn, arguments for centralization vs. decentralization in the "allocation," "distribution," and "stabilization" branches of European government. We do not aim for an exhaustive catalog of all possible policy areas. Our selection reflects both policy areas that are important in their own right and policy areas where the tension between the traditional and political-economy approaches is significant.

In these first three sections we consider each policy area essentially in isolation and also treat the assignment of tasks as perfectly controllable by a constitutional designer. This, of course, is not satisfactory when there are important *spillover effects* between different areas of policy-making. Section 5 of the paper therefore discusses prospective complementarities between reforms. We discuss examples where centralizing (decentralizing) some task to the European (national) level may create pressure to centralize (decentralize) policy in other areas as well and how the institutional rules (for rule-making) may decide whether such pressure results in actual centralization (decentralization) or not.

Two themes run through the paper. The first theme is that, when allowing for political economy considerations, straightforward normative conclusions on the appropriate degree of centralization are much more difficult to draw. The use of generalized second-best arguments requires a case-by-case approach and careful empirical analysis to measure the pros and cons of centralization and decentralization. Moreover, taking into account heterogeneity in preferences and interests in the context of given decision-making rules often leads to the conclusion that centralization hurts some interests but favors other interests, making normative conclusions difficult without relying on strong value judgments. Thus, we should not expect consensus on these issues to be easily forthcoming. This, in turn, is a strong argument in favor of a flexible approach to European integration. Forms of integration that seem appropriate for some countries or groups of countries in Europe are not necessarily appropriate for all of Europe.

The second theme relates to the existence of complementarities between policy dimensions. Complementarities imply that, in the absence of clear constitutional safeguards, the process of European integration is unstable and fragile. It also implies that a very flexible approach, without appropriate safeguards, could be very divisive. Some countries who begin to centralize some policy areas could find themselves very tightly integrated in all political and economic dimensions. Other countries that are more reluctant and stay behind could soon find themselves at the margin of the European Union, with few common interests with the rest of Europe. Thus, flexibility without appropriate safeguards could lead either to excess centralization or to a destructive unraveling of the existing achievements, or both.

Because normative conclusions on the optimal degree of centralization and decentralization are difficult to draw and because the process of European integration is unstable, European institutions must be given the right mix of flexibility and commitment. Some countries should have the option to experiment with centralization in new policy dimensions, while giving others the option not to participate. At the same time, all countries must agree to a more effective transfer of national sovereignty in the areas related to the Single Market, where there is clear case and a strong consensus that centralization and transfer of sovereignty are optimal for all countries. This solution, called flexible integration (Dewatripont et al. 1996) is spelled out in the conclusion.

## 2. Allocation

### a. Defense and Foreign Policy

Defense is one of the public goods where externalities of decisions are strongest. It is also the textbook example of a public good that should be provided centrally in a traditional Pigovian world of social welfare maximization. In Europe, however, there is a strong reluctance to transfer national sovereignty over defense and foreign policy to the European Union.

One way to think about this reluctance is as a coordination failure. Even if the population in European countries had shared the same rough objectives with respect to defense and foreign policy, they could still fail to organize a European defense and foreign policy because of the incentives to free ride on other countries. European indecision to act in the conflict in former Yugoslavia illustrates these incentives. With such coordination failures, the Pigovian recommendation to centralize remains valid. But one would have to find an appropriate institutional mechanism to enforce the centralized solution.

Another way to think about the absence of a common defense and foreign policy is, instead, to emphasize divergences in policy preferences: a common policy may contradict national objectives. The reluctance to centralize is reinforced if one takes an incomplete contract approach to politics (in line with Grossman and Hart [1986]). The incomplete contract approach recognizes that political institutions involve transfers of decision-making authority between different groups in the polity. Centralization, then, is not a fully designed contingency plan of how to use common troupes in different circumstances, but a delegation from national to European policy-making bodies of the authority to decide how to use these troupes. Many countries may feel that such delegation is too risky at the present stage of integration.

### b. Education

Here important externalities provide a strong case for government intervention or subsidies. At the same time, the *direct* cross-national externalities in Europe are not likely to be large enough that they motivate a centralization of educational policy, according to the traditional Pigovian approach. In fact, education policy is decentralized even in most federal states. Nevertheless, education and research policies have become one of the most important policy areas of the European Union over time, aside from the trade policies and transfer programs that form the core of the Community. This can only be understood with a broader view.

Most of the Union's educational programs do not, in fact, involve direct provision of education. Rather they aim at promoting *mobility* of students or researchers (see the ERASMUS or HCM programs). One effect of higher mobility is that it increases international competition between universities for students and faculty. Many observers take the view that national university systems in Europe are poorly organized and inefficient (particularly in comparison with the United States) because special sectoral and regional interests have led to inefficient regulation and to a poor allocation of government university budgets (see, e.g., Tabellini 1995). Stiffer competition, through greater international mobility, may give stronger incentives to reform these inefficient educational policies.

Another second-best argument could motivate some centralization of educational regulation, requiring teaching of foreign languages and analyzing curricula to allow easier communication. Such policies may—in the long run—foster greater labor mobility in Europe. Greater mobility may be seen as a goal in itself, or as a mechanism to enhance the benefits, or diminish the costs, associated with other European integration projects, like the EMU. For example, we know from the theory of optimum currency areas that factor mobility inside a geographical region is a criterion for an optimum currency area (Mundell 1961). Given that the evidence about the correlation of shocks across Europe is mixed (see, e.g., von Hagen and Neumann 1994), enhancement of factor mobility across countries may compensate for asymmetries in macroeconomic shocks across countries.

### c. Labor Market Policies

The Pigovian case for centralizing labor market regulations would have to rest on an argument about risks of harmful "social dumping"; that is, national labor market regulations would risk being diluted to socially inefficient levels, as different governments compete by reducing labor costs to attract mobile firms to locate in their own country. Occasionally Union officials and bodies have indeed argued in this direction. This externality argument is related to a call for centralization to prevent harmful "tax competition" when tax bases, such as capital (or goods), are highly mobile internationally. We discuss this argument in Subsection 3.c below.

Even though it is doubtful whether European business is mobile enough for this to be a valid concern, the argument may be altered once we introduce generalized second-best and political-economy concerns. For example, national labor market regulation may be subject to "regulatory capture" by trade unions (Bean et al. 1995; Saint-Paul 1993). If so, regulations regarding working hours, minimum wages, opening hours of shops, etc., are likely to be excessive, and some dilution of these constraints via regulatory competition may be helpful rather than harmful. The case for centralization is thus weakened.

A possible qualification has to do with the difference in decision-making at the central and national level. Trade unions, lobbying for labor market regulation, are strongly represented in the national political process in many European countries. They would likely have less clout in the policy-making process, if it were to take place at the central European level, at least under the present level of political integration (see, however, Section 4 below). Deregulation of rigid labor markets may thus be easier to pursue at the European level, much in the same way as it may be easier to avoid protectionist trade policies at the central European level than it would be at the national level.

### d. Competition Policy

Competition policy is one of the few policy areas where the central European bodies, in this case the Commission, has considerable powers to make decisions and to implement them (Neven et al. 1993). The Pigovian approach indeed calls for centralization of those aspects of competition policy that would potentially harm trade between European countries. The argument for centralization can be strengthened by the same logic as in the last subsection: if there is a larger risk of regulatory capture at the national than at the central level, then centralization would be helpful.

Under what conditions may we expect European regulators of competition policy to be less subject to capture by special interests than national regulators? On the one hand, the modern theory on the political economy of regulation under asymmetric inflation (Laffont and Tirole 1993) suggests that each layer of delegation in the regulatory process may give rise to prospective rents. Because the delegation chain from the "principals" (the European public) to the "agent" (the Commission) is particularly long and protracted we should expect more capture and rents at the European level. On the other hand, because European markets are much bigger than national markets, it is more likely that countervailing interests may find it worthwhile to organize at the European level. According to the modern theory of common agency (Bernheim and Whinston 1986), this may lead to less protective regulation, because of stronger competition between similar special interests.[1]

1 For an application of this theory to the political economy of trade, see Grossman and Helpman (1994).

To minimize the risk of the first effect and to maximize the possibility of the second effect, one should consider alternative institutional solutions. Generally speaking, a clear mission and maximum transparency would be useful features to promote the accountability of the European regulators. This would support the idea of functional separation of competition policy from the many other tasks performed by the Commission, and instead delegating this task to a specialized "European Competition Authority" (for a fuller discussion of this proposal, see Dewatripont et al. [1996]).

## 3. Redistribution and Risk Sharing

The traditional public finance approach definitely recommends that redistribution be centralized (Musgrave 1959). Yet, the redistribution branch of European government is very thin. That contrast provides a natural starting point for our discussion. We distinguish proper *redistribution*, aiming at reducing existing income differences between people or groups, from *risk sharing*, aiming at reducing the risk of prospective future income loss.

### a. Redistribution

The traditional Pigovian case for centralizing redistributive policies relies on two ideas: the first is the desirability of a broader base, the second is the possibility of internalizing (or rather ignoring) the effects of mobility of tax bases and hence avoiding inefficiently low tax rates due to "tax competition" between local governments.

We see very few redistribution programs at the European level, of course. *Why?* The simplest and probably also the most important reason is the same already mentioned for defense. Delegating authority over large-scale redistribution to the European level would not be perceived as legitimate given today's European institutions. The current mode of decision-making, where the Council of Ministers controls all important decisions, means that coalitions in Europe can only really be built between national interests. With an income tax, say, coalitions would naturally form along income lines, rather than geographical lines. But the resulting coalitions would not have a forum in which to affect European tax policy. Hence, the lack of legitimacy.

Naturally, this argument would be less forceful if the European Parliament were to acquire a bigger role over policy formation in Europe. But in this case, many express the fear that centralizing redistribution could set in motion a process of centralization that would be hard to control, and that in the end could lead to excessive centralization and excessive redistribution. One reason may be that inequalities between nations could create more opportunities for redistribution, and hence stronger political incentives for a majority in the European Parliament to expand the size of centralized redistributive programs. The fear that centralization would expand the size of redistributive programs is not always warranted, however, at least if one abstracts from mobility considerations. Having brought together the rich Germans and the poor Portuguese voters does not imply that the political outcome will entail more redistribution. In modern democracies, the size of redistributive programs is likely to reflect the preferences of the middle classes (namely, of the likely median voters), as opposed to the very rich or the very poor. To assess whether centralization increases or reduces the extent of redistribution in a political equilibrium, therefore, we need to tell how it affects the relative position of the middle classes. This depends on the shape of the distribution of income within each country. In the case of ex post income redistribution (as opposed to risk sharing programs), it could very well happen that the middle classes of a hypothetical federal European state are richer compared to the top end of the distribution than within many individual countries. That is, the distance between average and median income in Europe as a whole is likely to be smaller than the same difference within each European country (this argument is more fully developed in Persson and Tabellini [1994]). In this case, and abstracting from tax competition which we discuss below, centralization would dampen the incentives to expand the size of redistributive programs. The conclusion would be reversed in the case of risk sharing programs like unemployment insurance, however. In this case, centralization under a voting procedure would lead to an expansion of the program size (Persson and Tabellini 1994, 1996b).

One may also argue that too ambitious central redistributive programs could hurt the majority in some member states to such an extent that they may contemplate giving up EU membership. Such implicit threats of secession would constrain centralized policy, however (Buchanan and Faith 1987).

More generally, the reluctance to centralize redistributive policies at the European level is related to the differences in political majorities in individual countries and the majority likely to emerge at the European level (Bolton and Roland 1993, 1996). Differences in income distribution across countries imply that the majorities in individual countries have different preferences for the extent of redistribution. Centralization of redistribution policies at the European level would generate a new majority. Countries with a majority in favor of more redistribution may fear that there will be less redistribution in Europe, whereas countries where a majority favors little redistribution will fear excessive redistribution. Opt-out clauses may constrain redistributive policies (either upward or downward) due to the threat of secession. In some cases, an equilibrium centralized redistributive policy that does not lead to secession may not even exist. Interestingly, if there were increased mobility across European countries and European citizens were given automatic voting rights in their country of residence, such differences in political majorities across countries would tend to decrease, making agreement on redistributive policy at the European level easier to achieve (see also Sinn 1990).

The most extensive redistributive program in the EU, apart from the CAP, is related to the Structural (and Cohesion) Funds, which transfer resources to poor areas of the Union. Interestingly, the Structural Funds were instituted upon entry of the Southern European states and expanded at the introduction of the Single Market Program (the Cohesion Fund was instituted in the Maastricht Treaty). They can thus be seen as *side payments* to allow expansion of trade (or other EU integration). Presumably, they derived considerable legitimacy from being perceived as compensation to groups that stood to lose from expanded trade. They also can be justified on efficiency grounds. Indeed, increased mobility of goods and factors due to the Single Market may reinforce geographical concentration of wealth in given regions in the core of Europe, while peripheral regions get deserted by both labor and capital. The infrastructure and training programs of the Structural Funds are aimed at preventing such impoverishment in the periphery.

The current programs suffer from a "moral hazard" problem, however: a state (whose GDP per capita is above the threshold that is required for fund support) risks losing help if it pursues egalitarian or infrastructure policies that would lift the average income of its poor regions above the qualifying threshold. Such moral hazard would be prevented if the funds were handed out to countries instead of regions. This would however lead to other forms of moral hazard such as giving countries with lower income per capita less incentives to pursue growth or more simply incentives to underreport GDP. Given the intergovernmental mode of decision-making, it is not unlikely to think that direct net transfers between countries would appear as divisive and be vetoed or blocked by countries who would be net donors.

### b. Risk Sharing

The union also has no centralized social insurance or unemployment schemes. The reasons largely parallel those in the previous section. By analogy with the Structural Funds discussion, one may ask whether some centralized income insurance may derive political legitimacy from the start-up of monetary union. In fact, one of the original criteria for an optimum currency area was the existence of an area-wide tax transfer scheme (Kenen 1969). Many observers also point to the United States, where 20–35 percent (the estimates vary) of a regional shock is absorbed by the federal tax transfer system (Sachs and Sala-i-Martin 1992). It is true that individual countries could self-insure against temporary business cycle shocks through borrowing. But the fiscal constraints in the Maastricht treaty severely limit this possibility, and in any event no self-insurance is possible against permanent shocks.

An individual-based federal system is unlikely to be legitimate in today's Europe, as discussed in the previous subsection. It is indeed almost impossible to distinguish risk sharing and pure redistribution schemes, in practice (Persson and Tabellini 1996b). Another argument against centralized risk sharing is that it may increase the *political* risk for policy variation, even though it may decrease the *economic* risk with given policies (Alesina and Perotti 1995). (On the other hand, centralization will typically bring policy moderation and hence decreased policy risk relative to decentralization [Crémer and Palfrey 1996].) Finally, any inter-European risk sharing program would suffer from a moral hazard problem: countries would not have strong enough incentives to pursue policies that decrease the risk of income loss, or the economy's adjustment to shocks causing income loss (Persson and Tabellini 1996a).

An intergovernmental insurance scheme would be a more plausible and feasible option. This kind of system is likely to offer less insurance, if decided upon by an intergovernmental body like the Council. Since any government can veto the system, the scheme is likely to be dictated by the members who have the most stable incomes and hence have the least demand for insurance. This could reduce the relevance of the moral hazard problem, as countries would bear a larger fraction of their own shocks. On the other hand, an intergovernmental system could give rise to other problems of asymmetric information: national shocks would have to be explicitly measured, and this could give rise to adverse selection problems (Bordignon et al. 1996).

### c. Tax Competition

Setting aside the issue of centralized risk sharing or redistribution, is some form of tax coordination or harmonization desirable in Europe to avoid excessive tax competition on internationally mobile tax bases? The question has become particularly relevant now with regard to taxes on capital. The Commission is arguing that the tax burden on labor is too high compared to that on capital because the former is immobile, while the latter is becoming increasingly mobile. This distribution of the tax burden is inequitable and, it is argued, could be one of the causes of European unemployment. Indeed, even if individual labor supply is highly inelastic, trade unions could succeed in shifting the tax burden onto the firms, thereby reducing labor demand and increasing unemployment (Alesina and Perotti 1995). From the Pigovian perspective, there is a clear-cut answer: the externalities generated by fiscal competition impose an inefficiently low level of taxation and public good provision (Wildasin 1990, 1995; Gordon 1983).

This argument is not as convincing as it may seem at first sight, however. The modern theory of endogenous growth has emphasized that taxes on capital are highly distorting, too (Lucas 1990). Both labor taxes and capital taxes are harmful, because they reduce the incentives to accumulate physical and human capital. Indeed, the rise of European unemployment has gone hand in hand with a reduction in the trend of per capita growth. Thus, on efficiency grounds, we ought to be more concerned with trying to reduce the overall level of taxation than with reallocating of the tax burden from labor to capital. And some tax competition may be helpful, from this point of view. This is a generalized second-best argument: other forces may drive up the tax rates on mobile factors to inefficiently high levels. One such force may be credibility problems in capital taxation (Kehoe 1989), another is a private agenda for the government (Edwards and Kean 1996). In such cases, some tax competition may actually pull tax rates down towards socially more desirable levels. It may also force governments to reform state-run programs or enterprises which are managed inefficiently and are subject to the soft budget constraint syndrome (Qian and Roland 1994; Daveri and Pannunzi 1995).

Another reason for mitigating the importance of tax competition focuses more on political equilibrium effects. Suppose that the mobility of important tax bases, like goods and labor, rose a great deal in Europe, such that tax competition was perceived as a major threat to the level of the "welfare state" desired by a majority of the population. In that case, the majority may choose to appoint a government more committed to defend the welfare state. Such a move "to the left" throughout Europe would dampen the consequences on equilibrium tax rates of higher mobility (Persson and Tabellini 1992).

However, political economy arguments can also be invoked to show other undesirable consequences of fiscal competition. The adverse redistributive consequences of fiscal competition for those who live essentially on labor income may lead to a change in political majority in some countries, bringing to power a coalition who prefers to suffer the inefficiencies from closing its borders to prevent capital flight (Bolton and Roland 1993). Such effects may be particularly deleterious in Europe and jeopardize the achievements of integration. Recent strikes in individual countries like France show that existing Europe is blamed by many as responsible for reductions in redistributive programs.

## 4. Stabilization

The centralization of monetary policy has been one of the main driving forces of European integration, and the Maastricht timetable is clearly the main project for European integration. The pros and cons of a common European monetary policy are well known (see, for instance, Gros and Thygesen 1992), and we will not discuss them here. We focus instead on another question: How much fiscal policy coordination is needed among countries that have already fully centralized their monetary policy?

The simple Pigovian logic does not suggest a clear-cut answer. On the one hand, countries have already given up the monetary policy tool to deal with idiosyncratic shocks. Stabilization of such shocks would therefore require that countries be relatively unconstrained in their fiscal policy choices, particularly with regard to the size of budget deficits. On the other hand, common macroeconomic shocks may require a coordinated response (see, for instance, Frenkel and Razin 1985).

This is clearly not the view taken in the Maastricht Treaty. According to the treaty, countries should be free to pursue any mix of spending and taxing policies, provided that budget deficits are roughly balanced. Constraints on the size of budget deficits inside a monetary union are suggested by a simple credibility argument. Countries with a high public debt have an incentive to inflate the debt away, or at least to engage in a looser monetary policy, to reduce the interest burden, and maybe to devalue their debt obligation. Moreover, seignorage revenue is more valuable. Thus, monetary policy credibility is hurt by large debt and deficits (Lucas and Stokey 1983; Persson et al. 1987; Obstfeld 1990).

In a monetary union a free rider (or common pool) problem makes this credibility problem more serious. The public debt of countries in a monetary union are likely to be relatively good substitutes, since they are free of exchange risk. Hence, it is more likely that public debt is widely held outside national borders. But this, in turn, suggests that a single country may have less to fear from public debt default, because it could expect to be bailed out by its monetary partners. The bailout of, say, Italy is more likely if Italian public debt is widely held throughout the Union, to avoid losses by financial institutions or by European households. The expectation of a bailout naturally creates a moral hazard problem, and weakens the incentives to pursue a balanced budget. All of this implies that limits on debts and deficits are indeed suggested by sound economic theory, even though the precise quantitative constraints imposed by the Maastricht Treaty are arbitrary.

But limits on debt and deficits also give rise to some fundamental challenges. One difficulty with fiscal constraints is how to enforce them. Evidence concerning the U.S. states indicates that limits on debt and deficits are easy to sidestep, by means of off-budget items and creative accounting (von Hagen 1991; Bohn and Inman 1996). Moreover, fines and other pecuniary constraints may be politically unfeasible, and in any event they make the problem even worse for a country in violation of a deficit constraint.

A second difficulty is an excessive transfer of sovereignty to Brussels. In practice, constraints on fiscal deficits will imply that each country in the monetary union could have to negotiate its yearly budget with a restricted Council of Ministers, consisting of the other countries also in the monetary union. German and French proposals of an ECOFIN restricted to the countries participating in the euro suggests that indeed this is a possible outcome. But such an arrangement would be very dangerous. First, it would be divisive, for it would create a political barrier between the "ins" and the "outs" of the common currency. Second, it would entail a deep political integration between the countries participating in the common currency, without creating appropriate political institutions. Joint political decision-making without adequate political representation would create a confusion of responsibility and reduce accountability: national citizens would not know whom to blame for mistakes or inequities. Council decisions already lack transparency. Imagine that the Council became in charge of sensitive political issues concerning budgetary problems inside individual countries. Moreover, as we already remarked, minority interests are inadequately represented within the Council. Therefore, such interests could be severely harmed by a transfer of sovereignty to Brussels.

## 5. Complementarities

The discussion in the previous section indicates that a centralization of monetary policy through monetary unification affects the costs and benefits of fiscal centralization. On the one hand, it could become necessary to impose fiscal discipline through deficit targets like the Maastricht criteria. On the other hand, once monetary union is achieved, one can expect arguments advocating more fiscal coordination. If price stability is the objective of monetary policy and if national governments are forced to balance their budgets, response to macroeconomic shocks will require the use of fiscal policy instruments at the European level, thereby leading to stronger demands for a bigger EU budget and possibly for EU deficit spending. In any case, even the simple enforcement of balanced budget rules by national governments requires additional enforcement powers at the supranational level, which, in turn, requires a higher legitimacy of supranational institutions, which, in turn, reinforces the need for political reforms. Centralization of monetary policy thus increases the benefits of fiscal centralization and of political integration.

This illustrates the role of complementarities between various policy dimensions, something which has so far been neglected in the theory of fiscal federalism. These complementarities play an important role in reality. There are no examples in history of large and politically powerful countries that have completely delegated their monetary policy to an independent supranational agency, while at the same time retaining their political autonomy.

Complementarities are also important outside the spheres of monetary, fiscal, and political integration. Enforcement of free trade of goods and services and the free movement of factors often require supranational instruments or even some form of political integration. The stronger this supranational enforcement the stronger the credibility of free trade. Free trade is of course better enforced in the long run inside a federal state than across independent countries, if only for the reason that peace is generally better enforced inside a country than across countries. Supranational institutions like GATT and now the WTO play an important role in enforcing free trade across the world. The success of Europe in the last decades in enforcing increased economic integration across borders is precisely based on the objective of closer political integration laid out by the founding fathers of Europe. This success explains why countries belonging to EFTA whose initial ambitions were restricted to free trade were eventually attracted to the EU.

Complementarities across policies imply that a move towards centralization or decentralization in one dimension increases the benefit of moving in the same direction in other dimensions. What do such complementarities mean for the analysis of European integration? First, they indicate a possible danger of rampant centralization. The European integration process is and has always been very open-ended, without safeguards against excess centralization of powers in Brussels. This open-endedness is, to a certain extent, deliberate and has been part of the strategy between federalists in Europe. They have been pushing for further integration along dimensions politically feasible at a given point in time in the hope that success in partially integrating along those dimensions would build constituencies for further integration along other complementary dimensions.[2] This is how the success of the Common Market, together with insufficient enforcement of free movement of goods and services led to the adoption of the Single European Act in 1985, also known as the "1992 program." The success of the Single Market led to plans for monetary unification which led to the Maastricht Treaty. One can carry the logic further. Once monetary unification is achieved successfully, arguments for fiscal centralization and increased political

2 See Dewatripont and Roland (1995) for a theoretical analysis of the political economy of the sequencing of reforms.

integration will become more compelling, generating a of further integration movement.

A successful monetary union would not only build constituencies for further integration but also weaken opposition to further integration. Indeed, monetary union will raise the cost of exit from the union. The threat of exit is really the reason why EU countries search for consensus on decisions in the Council even when majority voting is allowed for. Monetary union will make the threat of exit less credible and thus further weaken the veto power of countries who oppose further integration. Open-endedness of the integration process thus gives federalist forces the option of pushing for more integration in the future. Indeed, if future limits to integration had been set down explicitly in the treaties, it is likely that these limits would reflect the balance of power of the moment between federalists and antifederalists, making renegotiation much more difficult. But in the current situation, and given the rapid advances of European integration in the past 10 years, this open-endedness may be a source of political deadlock. Those who fear that the dynamics of integration may end up in excessive centralization will reject further integration because of the fear of these dynamics and not because they object to the proposed reforms in themselves. One may indeed interpret the rejection of the Maastricht Treaty in the first Danish referendum and opposition to monetary union among large fractions of the European public as a strategic rejection of a process towards excessive centralization.

A similar but opposite argument applies to the countries left behind in European integration. Because of complementarities in reform, these countries could find themselves pushed more and more towards the margins of the Union, to the point where doubt is cast on the benefits of existing forms of integration.

This leads us to the second implication of complementarities in reform, namely the danger of divisiveness between two groups of countries, and, more generally, the danger that past integration may unravel. Any partial reversal in the process of integration will decrease the costs of reversal in other policy dimensions. One can think of a scenario where plans for EMU fail to be achieved, strengthening the camp of those who criticize anything coming from Brussels. This could easily hamper the free mobility of goods and services, bolster various forms of protectionism and possibly raise barriers to capital movements to fight tax competition. Moves by individual countries may trigger retaliation by others, leading to further escalation, whereby the achievements from past integration may eventually be lost. Given that EMU has been decided, many in Europe think that the main reason to go ahead is to avoid such unraveling rather than to obtain the economic benefits of monetary union.

This discussion on complementarities between policy dimensions shows that any discussion about the benefits of centralizing certain policies involves not only their intrinsic benefits and costs but also certain externalities on the costs and benefits of centralizing other policies. These complementarities are stronger between certain policy areas than between others. We do not observe only separate countries and centralized states. Many states have a federal or confederal structure. However, even in federal states there are movements in the direction either of centralization or decentralization (see, e.g., Riker [1964] on the process of centralization in the United States since the New Deal). These movements are however much more inertial than those observed in the course of European integration. Federal and confederal constitutions generally include safeguards to avoid either excessive centralization or decentralization of powers. In the current stage of European integration, the absence of such safeguards may become a source of political deadlock, rather than an option for further integration. It has become urgent to clarify the "constitution" of Europe and to bring about reforms in its decision-making process. It may be mistaken to think that such reforms could be delayed until after monetary union, because the absence of such reforms may undermine support for the monetary union and lead to a breakup of past integration.

## 6. Conclusion

The political economy approach to fiscal federalism makes it more difficult than the traditional Pigovian approach to derive clear-cut normative recommendations concerning the optimal assignment of tasks to various levels of government. This is particularly relevant in the European context, where there are more diverging interests across individuals and states. Europe will have to be flexible enough to allow different countries to integrate at different speeds or over different policy areas. Moreover, complementarities across policy dimensions make the process of integration unstable, with dangers of unraveling and divisions along the way.

What is the appropriate institutional response? A solution called "flexible integration" has been put forward in Dewatripont et al. (1996). Its main ingredients are as follows. The European Union should have a double structure of competences: a *common base* and a set of *open partnerships*. The common base would consist of the policy areas over which all members of the Union agree upon and which are deemed essential to preserve free trade and mobility inside Europe. This mainly consists of the Single Market and whatever else is necessary (economically and politically) for its survival and smooth functioning. Open partnerships would regroup subsets of the Union with countries wishing to share additional policy dimensions without forcing other members to join.

This structure would allow countries to experiment with integration along new dimensions without making any binding commitment to other countries.

Success would prove the usefulness of transfer of sovereignty along these new dimensions and may convince countries who were reluctant to join initially and to make the new policy part of the common base. Failure would make countries abandon the open partnership. In order to avoid unraveling, policies of the common base should be subject to a clear transfer of sovereignty to European institutions. This means giving more enforcement power to the Commission and to European executive bodies. Such powers could be made more legitimate through reforms that give voters more direct control over European executive bodies, and reforms that allow cross-border voter coalitions to form and play a role.

Europe is now facing fundamental new challenges, such as enlargement to Central Europe and contributing to peace in the postcommunist world. We must recognize that having a single money, a common foreign policy, or a common defense policy is not the same thing as having a single market. Our institutions must adapt in order to deal with these new challenges, without jeopardizing the gains from past integration. The importance of the external challenges makes the reforms urgent.

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