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Comment on Stefan Collignon: "Fiscal Policy and Democracy in Europe"

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Before starting, I would like to say that in this presentation I will express my personal views, which do not necessarily represent the official views of the ECB.

Let me begin with a frank approach. Professor Collignon seems to me a European federalist. Living in the UK, he might take this as an insult, but it is not meant as an offence, rather as a compliment. He favours the introduction of a Euro tax to finance the EU budget under the authority and control of the European Parliament. In order to justify his argument he quotes the theory of fiscal federalism and finds that it is advisable to centralize the redistribution and stabilisation functions. However, he is taking federalism as given, which might be taking too much for granted. On this basis he embarks on an analysis over the EU budget to substantiate the proposal for an EU tax, which could lead to efficiency gains in redistribution and stabilisation policies. Professor Collignon concludes that this would contribute to remove the fiscal constraints by the Stability and Growth Pact on net contributions to the EU budget.

I disagree with this line of argumentation. I think the role an EU tax might play in the redistribution and stabilisation policies of the current EU is overestimated.

Let us go, first, to the macroeconomic stabilisation function. He claims that a centralised budget is better able to confront externalities associated both with taxation and expenditure. This is true, but one can also use regulations and specialised agents to internalise these externalities. Currently, we do have specialised agents, in this case the European Commission, and we have a clear regulation to internalise possible externalities in a monetary union associated to for example the free riding incentives of participating member states.

With regards to the redistribution function, he finds that the EU budget is basically a redistribution budget, 40% of the overall expenditure is dedicated to agricultural policy and 40% to cohesion funds, and that these transfers undermine fiscal discipline and European stability. Such a type of redistribution does not provide a regional insurance against asymmetric shocks either, as the funds were not designed with this stabilising purpose in mind. The agricultural expenditures

are an income support scheme for the farmers and the cohesion funds aim at fostering development of the less developed countries. Of course, we can enquire whether these funds are really complying with their function and whether it is good to keep devoting so many resources to these aims. In fact, from an economic point of view the argument would be that these funds are in general inefficient. To guarantee farmers' income through output subsidies generates distortions. To foster development, the current cohesion funds do not seem to be the most appropriate instrument, because, in the end, they are also an income support fund without any incentives to change the situation of regional underdevelopment.

Following on these arguments, Professor Collignon says that what matters for macro stabilisation is the policy mix and that a single monetary policy requires a unified aggregate fiscal policy stance. He, therefore, argues for a centralized decision on deficit and then proposes to allocate the deficits to the Member States, with tradable permits to allow for deviations from the allocated deficit quota. The mechanism would be that the European Commission proposes the aggregate fiscal policy stance defined by the aggregate deficit, the European Parliament gives its approval and the Council implements the agreement. I have doubts on this proposal. I do not know whether this would be really an improvement in the democratic process with respect to the current situation. Although Member States accept some limitations to their fiscal autonomy in order to prevent externalities, they are not willing to give up their full fiscal sovereignty.

I would say that the current budgetary constitution of the EU reflects the degree of political integration acceptable for Member States. It is a very delicate mechanism, which balances the powers of the Member States to undertake the fiscal policies they see appropriate within a set of rules, which limit negative effects on the other Member States. At the same time it is also a very subtle mechanism in which the Commission is the only specialised agent with the capacity to take the initiative in order to trigger the appropriate procedures that make Member States comply with fiscal discipline. On the other hand the Council is the only institution with the power to take decisions regarding the implementation of these fiscal rules. The Member States find themselves in between the Commission and the Council trying to preserve full fiscal sovereignty without any interferences. All in all it is a relatively delicate system, which can be easily unbalanced if this complicated architecture is biased towards one direction or the other.

There are good arguments to defend a European federal level of government, but these arguments are not founded on stabilisation or redistribution. There are certain public goods like security or defence, which probably would be more efficiently provided at the EU-level than at the state, regional or local level. But there are also other services, for example the enforcement of law etc., which are possibly better provided at a lower level of government. And there are also some merit goods which generate important external economies. A good example would

be higher education and research, which for reasons of external economies and economies of scale might be better provided at an aggregate scale at the European federal level.

If there are some good arguments to spend money at the level of the hypothetical European federal government, probably an efficient way to finance these expenditures, is through taxation. I would agree that taxation of the most mobile factors of production, capital or corporate profits, seems to be an appropriate instrument to finance these federal expenditures.

The draft constitution of the EU clearly reflects the current political realities, but this does not preclude the development of further commitments at the European level in the area of public expenditure and taxation. Therefore, I would like to thank Professor Collignon for this thought provoking paper, which I have enjoyed reading very much.