International Review of Law and Economics (1994) **14**, 147–161

The EMU and Fiscal Policy in the New European Community: An Issue for Economic Federalism[1]

ROBERT P. INMAN

University of Pennsylvania

AND

DANIEL L. RUBINFELD

NBER and University of California, Berkeley

As the countries of Western Europe move to a more centralized economic order, questions of federalism abound. A primary issue within the European Community (EC) relates to the often-used concept of *subsidiarity*: the guiding principle that government structure should internalize all economic externalities to the smallest level of government possible. To what extent should economic powers in the EC be centralized, and to what extent should they remain decentralized at the Member State level? This paper examines the general issue of federalism, or subsidiarity of economic policy, by evaluating the possible allocation of monetary and fiscal policy within the new EC.

To determine whether a policy-making function should be centralized or decentralized, three questions must be answered. First, does decentralizing policy-making to the level of the Member States generate substantial economic spillovers between states? Second, if the answer is yes, we then ask whether a market mechanism or negotiated exchanges (i.e., Coasian bargains) will overcome the potential inefficiencies from these policy spillovers. If the answer here is no, we then turn to the possibility of centralized policy-making and ask, finally, can a central government perform the policy function more efficiently than individual Member States, recognizing that private politics, not social welfare, will be the driving motive behind central government decisions? Only if the answer to this third question is yes can we recommend centralizing government policy-making.

In Section I we review the benefits and costs of a European Monetary Union (EMU); our reading of the literature suggests that, on balance, the net economic benefits of an EMU to the Member States are potentially positive. With the centralization of monetary policy, however, Member States are now potentially exposed to the adverse consequences of asymmetric, country-specific economic shocks. Can Member State fiscal

[1]The authors gratefully acknowledge support from the Smith Richardson Foundation and the Center for Advanced Study in the Behavioral Sciences. They wish to thank Barry Eichengreen, Geoffrey Garrett, Peter Hall, Karen Lewis, Susanne Lohmann, and attendees at the Vitznau conference for their helpful comments and suggestions.

© 1994 Butterworth–Heinemann

policies effectively offset those shocks in an open European economy? We think the likely answer is no. It is here that we identify a potentially important spillover between Member States. If country-specific shocks are important, and if those shocks are asymmetric (i.e., only weakly correlated), then members can pool their resources to ensure against adverse consequences.

In Section II, we evaluate other means by which the EC can respond to country-specific, asymmetric economic shocks; they include labor market adjustments, privately provided unemployment insurance, or negotiated labor-management coordination. Because of cultural and language barriers, the relocation of labor or adjustment of wages is unlikely to fully clear European Member State labor markets in times of localized recessions. Private unemployment insurance will require both EC-wide insurance to fully pool country employment risks and sufficient assets to withstand a major, EC-wide recession. While existing regulatory barriers to EC-wide insurance can be removed, competitive private firms may find it difficult to collect sufficient premiums to cover losses during an economic disaster. Finally, labor-management coordination of employment and wage decisions across European states, while promising in theory, seems a distant hope at this time. We conclude, therefore, that neither markets nor Coasian bargains in the new EC will fully internalize the economic costs of country-specific, asymmetric economic shocks. There is therefore sufficient economic basis for considering—though not yet embracing—a centralized fiscal authority.

Section III looks at EC federalism from a political perspective; we evaluate the possible political outcomes if fiscal policies are centralized following the creation of an EMU. The benefits and costs of centralization are seen to depend heavily on the political institutions primarily responsible for setting fiscal policy. If decision-making power within EC institutions is itself centralized (e.g., within the Council of Ministers), then we conclude that good fiscal policies capable of ensuring against asymmetric shocks can be enforced. However, if decision-making power within the EC is decentralized (e.g., within the European Parliament), we are less confident good fiscal policies will result.

Section IV comments on the implications of our analysis for economic federalism more generally.

I. A European Monetary Union?

The Maastricht Treaty creating an EMU was successfully negotiated in December 1991 and received final approval of all Member States in October 1992. The treaty seeks to ensure more open borders for Member States in the movement of goods, labor, and capital, and a common monetary policy for all Member States through a European Monetary Union with a single currency and a single central bank. While evidence seems conclusive on the advantages of more open borders (see Emerson et al., 1988), the economic pros and cons of an EMU are more controversial. We briefly review the evidence here.[2]

A. The Benefits of Monetary Unification

The benefits of monetary unification are fourfold. First, with a common currency, the EMU should lower the transactions costs of doing business in the EC. While this gain

[2]De Grauwe (1992) and Eichengreen (1993a) provide more detailed analyses.

is not large, it is clearly significant. The Commission of the European Communities (1990) estimates the current costs of monetary conversion to be approximately 0.1% of gross domestic product (GDP) for large states, but as high as 1% for small, open, less-developed economies.

Second, the EMU has the potential to ensure greater overall price stability in EC countries. Whether it will do so or not depends substantially on whether (1) national central banks will be prevented from engaging in excessively expansionary monetary policies, and whether (2) the European Central Bank (ECB) under EMU will achieve a degree of political independence that is comparable to that of the German Bundesbank. Gros and Thygesen (1992) suggest that a centralized Federal Reserve System, similar to that now used in the United States, could solve these problems.[3]

A third potential benefit from EMU relates to market integration; EMU could further encourage trade among EC Member States. Emerson et al. (1988) suggest that the magnitude of the potential benefits of an open-European economy are large. While there is little disagreement that the gains in a single market are large, the marginal benefits of EMU remain hotly debated. Thygesen (1993) suggests that the benefits of EMU are substantial, because the value of exchange-rate stability increases as economies become more open; Eichengreen (1993b) believes they are overstated.

Fourth, and finally, to the extent that a common currency leads to exchange rate stability, increased capital formation in the EC may result. The stability of exchange rates within EMU can reduce currency exchange risk and therefore encourage capital mobility among EMU Member States. These capital flows can be expected to increase overall productivity in the EC.[4]

B. The Costs of Monetary Unification

There are clearly well-defined benefits associated with EMU, and they may be substantial. The costs of EMU are more problematic. One important advantage of a decentralized exchange rate system is that nations can devalue their currency in response to an economic shock. If economic shocks affect all or most of the EC countries similarly, then a common exchange rate controlled by the EMU can serve effectively the same function. However, to the extent that the shocks are country specific, asymmetric, and substantial, as Bayoumi and Eichengreen (1993) suggest they may be for Members of the new EC,[5] then the loss of country-specific monetary policy may be very costly.

The costs to the individual Member States of the EMU of losing control over domestic monetary policy depend first on whether those policies now effectively stimulate aggregate demand in times of localized recessions. Eichengreen (1993b) concludes that such policies have been effective in the larger countries of the EC. De Grauwe (1992, Chapter 2), however, suggests that in the small, open economies of the EC the

[3] The effect of the current European Monetary System (EMS) on inflation is not clear. While inflation rates in Europe did decline and converge during the 1980s, the causal link to the EMS is uncertain. Thus, Eichengreen (1992) believes that "changing attitudes toward inflation were conducive to exchange-rate stability and the emergence of the EMS, not that the EMS played a causal role in bringing down European inflation."

[4] The evidence suggests that capital flows in the EC are likely to be substantially more sluggish than in the United States, however. See Eichengreen (1990b) for the evidence.

[5] Bayoumi and Eichengreen correlate output fluctuations and inflation rates in the United States and in Europe. They find correlations to be substantially higher in the United States. See also Eichengreen (1990a,b, 1991).

ability of monetary policy to reduce temporary unemployment is considerably less. If monetary policy is ineffective in reducing the adverse consequences of asymmetric demand shocks, then the costs of losing that policy to an EMU are zero. The small, open economies of the EC—Ireland, Belgium, The Netherlands, Portugal—should therefore be supporters of an EMU; indeed, this appears to be the case.

For the larger EC countries, the potential benefits of the EMU come at a price, however, the loss of effective monetary policy to manage country-specific recessions. This cost could be reduced if the use of fiscal policy were an effective alternative policy, as it might well be in the larger EC countries.[6]

The aggressive use of local fiscal policy to control local unemployment has its own risks, however. First, as Canzoneri and Diba (1991) argue, when capital is mobile, an expansionary fiscal policy in one country may lead to higher interest rates in that country and elsewhere if that country's demand for funds is large relative to the relevant capital market. As a consequence, interest rates may increase throughout the EC as one member adopts an expansionary fiscal policy. Inefficiencies will then be created to the extent that other, nonexpansionary governments are forced to raise distortionary taxes to finance the interest charges on their own debt.

Second, if capital markets anticipate a central government "bailout" of large local government debts, then there are moral hazard reasons to expect excessive local government borrowing; see Sibert (1991) and Buiter and Kletzer (1990). Such bailouts are most likely when the country is large and its debt becomes an important part of other member country portfolios.[7] Both arguments suggest that there may be important negative spillovers from the use of decentralized deficit policies for managing unemployment risk.

There is an alternative fiscal policy strategy that will reduce the costs of the EMU to large country members and provide an added benefit to small country members. This is a central government policy of cross-country fiscal assistance in times of country-specific recessions. Such assistance can be paid as grants to the ailing country or directly as assistance to families in unemployment. Transfers would be paid from a centrally managed fund into which all EC-member countries make contributions. To the extent possible, contributions should be experience rated based on each country's cyclical history of employment. In effect, such policies are insurance policies among Member States in which the Member States pool their risks of country-specific, asymmetric unemployment shocks. Here is an example of a positive spillover among all EC countries—risk pooling—that central government fiscal policy can internalize.

The United States uses such insurance programs extensively. They include unemployment insurance (mandated by the central government, but financed primarily by the individual states), progressive federal taxation (primarily the personal income tax), progressive government grants (allocated by the federal government in part on the basis of state income), and federal income redistribution programs (including Aid to Families with Dependent Children and Medicare). Sachs and Sala-i-Martin (1992) es-

[6]Our own analysis of the United States [Inman and Rubinfeld (1992a)] provides empirical support for the view that Keynesian policies are potentially effective in large Member State economies. For example, we find the economy in California is sufficiently large and independent of its neighboring states that its own fiscal policy may well have an effect on unemployment. Most other U.S. states' economies are too small and too interdependent for fiscal policy to be effective. Gramlich (1987) reaches a similar conclusion.

[7]The decision of New York State and finally the U.S. government to provide loan assistance and guarantees to New York City after its fiscal collapse in 1975 offers one example of such a bailout.

timate that the U.S. system of coinsurance offsets about 35% of any income loss that an individual state suffers. While this effect may be overstated, since it includes insurance of permanent as well as cyclical shocks, it is clearly significant.[8]

Currently, the EC does not have the fiscal capability to effect substantial intergovernmental transfers, however. The EC budget is only about 1% of EC gross domestic product and 5% of the government spending of individual EC members. If the EC is to engage in the provision of substantial intergovernmental transfers, a number of important options must be considered. First, the EC must decide whether transfers are to be person specific or region specific. Region- (or state-) specific transfers are less desirable since they run the risk of perpetuating permanently depressed regions and consequently discouraging the efficient location of economic resources. Structural funds that are aimed at regions such as southern Italy are unlikely to be effective in the long run. Person-specific transfers are to be encouraged.

Second, the EC should consider the introduction of a system of EC unemployment insurance. There are risks, of course, since insurance creates moral hazard, as, for example, when domestic labor unions push for higher wages, knowing that the costs (unemployment) will be borne by the central government. But, we believe that the program can be worthwhile. Mimicking the U.S. structure could resolve the moral hazard problem; in the United States individual states manage their own unemployment trust fund.[9]

We conclude that the potential net benefits from centralizing European monetary policy are positive *if* a suitable alternative policy can be implemented to neutralize the adverse employment consequences of country-specific, asymmetric shocks to aggregate demand. Country-specific fiscal policy is likely to be ineffective for the small, open economies of the new EC. For the larger members of the EC, own fiscal deficits may have adverse negative effects on fiscal efficiency in neighboring countries and may create a moral hazard incentive when the risks of default are shared within the Community. Rather than country-specific fiscal policies, EC-wide fiscal policies might be considered. One such policy involves cross-country risk sharing through a centrally administered, experience-rated transfer program. This program can either compensate countries via EC grants-in-aid tied to country unemployment rates or compensate individuals via individual-based unemployment insurance payments. At the moment, however, the EC lacks both the tax structure and the fiscal institutions needed to implement such schemes.

II. Private Control of Country-Specific Economic Shocks

We see three alternative nongovernmental responses that might arise to help EC nations respond to asymmetric economic shocks following entrance into an EMU. They are (1) private labor market responses that lower wages or reallocate workers; (2) private market insurance for country-specific unemployment; and (3) negotiated labor-management coordination across EC countries to adjust wages and employment in times of offsetting booms and recessions.

[8]Bayoumi and Masson (1991) estimate a 20% effect.

[9]Individual states do pay a fraction of their payroll taxes into a Federal Unemployment Trust Fund, which they can draw from if there is a deficit. However, they must pay interest on the account.

A. Labor Market Responses

In a fully responsive private economy one would expect a recession in one country, say, Italy, to lead to a decline in the demand for workers there, a fall in wages, and an outmigration of workers to other countries where wages are higher and jobs are more plentiful. A consequence of this outmigration is that wages in Italy will rise to a new equilibrium level. Both migration and wage adjustments mute the effect of the adverse shock on Italy, in effect, by sharing its negative impact on labor incomes among the workers of the other nations in the EC.

How effective are these private labor market responses in the EC likely to be? We are not optimistic. Even in a fully open economy such as the United States, we found that labor market adjustments were relatively slow.[10] Moreover, even if border controls were eliminated in the EC, cultural and language barriers would still be likely to limit international labor mobility.[11] In addition, there is evidence suggesting that wages are less flexible in Europe than in the United States.[12] On balance, therefore, it seems unlikely that labor market responses to adverse economic shocks will be satisfactory from the point of view of the EC.

B. Private Unemployment Insurance

If labor markets do not fully adjust to the uncertain swings in aggregate demand, workers may seek to purchase private insurance against spells of unemployment. Three problems must be overcome before such a market can function efficiently. First, insurers must be informed about each worker's risk of unemployment. If not, the problem of adverse selection in which bad risks drive out the good risks may preclude writing profitable policies. Second, insurers must be able to monitor worker behavior to distinguish periods of valid unemployment from unwarranted quits. If not, such worker moral hazard may again undo firm profitability.

Finally, private firms must be able to pool the risks of unemployment using the premiums from workers who remain employed to pay the benefits of workers who fall into unemployment. Importantly, this will mean insurance companies must be allowed to write policies across all, or at least several, EC countries. While current insurance regulations have limited this option, new EC market regulations should permit such cross-country insurance pooling.

Regulatory restrictions aside, there is the deeper economic problem of the likely inability of private firms to insure against unemployment during major EC-wide recessions of long durations, as, for example, Europe is now experiencing. In this case firm assets may be exhausted, and EC central government bailouts will be necessary. While such events may be rare, the fact that they can occur creates a new moral hazard problem, now between private insurance firms and the EC central government as the insurer of last resort. When are bailouts justified and when are they not? Detailed government regulation of private firm performance might be required to answer this question. In the end, what we are likely to observe is private insurance in name only.

---

[10]Inman and Rubinfeld (1992b). Blanchard and Katz (1992) reach a similar conclusion.

[11]Eichengreen (1993a) finds that even within-country migration is less responsive in Europe than in the United States.

[12]See Eichengreen (1992, Table 3), which shows that the elasticity of nominal wages with respect to the unemployment rate is lower in all EC countries than in the United States. See also Bruno and Sachs (1985).

C. Labor-Management Coordination

If private markets are unlikely to respond efficiently to adverse economic shocks, there is an alternative solution to the externality that is created, Coasian bargains across private actors in the EC. Coordinated wage bargaining (CWB) across unions and employers in the EC might be imagined. CWB is a system of informal agreements between employer associations and centralized trade unions to smooth employment shocks across industries. One would expect, other things being the same, that coordination can substitute for the market. When an adverse economic shock affects one region or industry, unions and employers can agree to adjust wages downward in that sector and to the extent possible to offer jobs elsewhere. Unions would encourage workers to migrate to those jobs, and employers would agree to hold wages down so that new workers can be absorbed. To the extent that the bulk of the adjustment occurs through increased migration, CWB should lower overall unemployment rates and reduce wage dispersion.[13]

Recent empirical studies of average levels of unemployment across OECD counties with varying degrees of wage coordination generally support the view that CBW can have a positive effect in lowering the national rate of unemployment. Freeman (1989) and Calmfors and Driffill (1989) both find that countries with centralized labor organizations that coordinate bargaining have lower average levels of unemployment. The mechanism that lowers unemployment in the centralized labor countries appears to be a form of informal cross-sector employment insurance facilitated through countrywide moderations in wages. Wage dispersion is much less in the countries with coordinated wage bargaining; see Freeman (1989). Interestingly, particularly in light of our arguments in Section II.A above, countries with the most competitive labor markets also have low average levels of unemployment. Here wage adjustments and labor mobility ensure low rates of unemployment; again, see Freeman (1989) for the evidence.

Soskice (1990) extends the Freeman and Calmfors–Driffill analysis by allowing for coordination on the employer side as well. Coasian bargains should be most likely when there are centralized employer associations dealing with centralized labor associations. Soskice's more complete index of coordinated wage bargaining confirms previous results and improves the fit of the relationship between labor market coordination and low unemployment.[14]

---

[13]A CWB system has been effective within Germany. The German workforce is organized into 17 industrywide unions; in addition, 80% of all employers belong to employer associations. Initial industry wage bargaining with an individual company can be extended by German law to cover all companies in an industry. Because unions and employer associations span industries and regions in the German economy, both have an incentive to consider the health of the overall economy when bargaining. It should be noted that the Bundesbank also plays an important role in labor negotiations in Germany. The threat of an increase in interest rates or exchange rate evaluation has been used by the Bundesbank to encourage labor-management bargains to avoid overly inflationary agreements.

[14]A simple econometric test of our own using a somewhat richer database on unemployment (Alesina and Summers, 1993) and Soskice's (1990) measure of central bargaining confirms the Soskice results favoring coordinated wage bargaining. The average unemployment rate (AVEUE) for the years 1955–1988 is regressed on Soskice's index on coordinated wage bargaining, CWB (5 = highly coordinated, 0 = uncoordinated) for the ten countries (values of CWB and AVEUE included in parentheses) included in the Soskice study: United Kingdom (0; 6.7), France (1.5; 6.1), Italy (2; 7.3), Norway (4; 6.1), Sweden (4; 6.1), Netherlands (3; 4.2), Japan (5; 4.9), United States (0; 4.1), Germany (3.5; 3.0), and Switzerland (4; 3.2). A linear relationship between AVEUE and CWB shows CWB to have a statistically significant negative effect on average unemployment over the 33-year period. (Standard errors of pa-

The evidence here suggests that coordinated wage bargaining does appear to lower unemployment rates in within-member EC countries where labor and management work together. Unfortunately, however, the labor-management institutions required for similar coordinated wage bargaining across EC countries are not yet in place. Until those institutions develop, the Coasian solution to the problem of asymmetric, country-specific employment shocks is not available.[15]

In summary, private market innovations within the EC that significantly enhance cross-country labor mobility, allow for private unemployment insurance, or permit coordinated wage bargaining are not likely at this time. We return, therefore, to consider the prospects for implementing centralized EC-wide fiscal policy to moderate the consequences of country-specific economic shocks.

III. The Political Management of Centralized Fiscal Policies in the EC

The success of a centralized fiscal policy depends crucially on the makeup of the authority responsible for making policy and on the political incentives that it faces. In this section we briefly outline the proposed political structure for the EC. We then characterize the likely politics of a centralized fiscal authority. Following this we evaluate the potential for successful fiscal policy in the EC.

A. The Political Institutions of EMU and EC Economic Policy-making

The road toward EMU began in 1987 with the ratification of the Single European Act, in which the twelve original EC members agreed to complete an "internal market" by 1992. It was also agreed at that time that unanimity voting would be replaced with qualified majority voting. Furthermore, members agreed to continue to abide by the understanding that EC law would have supremacy over national laws. In addition, EC law would have "direct effect" in individual Member States, whether or not it was explicitly incorporated as such through legislation.

The next major step toward EMU came with the passage of the 1991 Maastricht agreement. Maastricht envisioned a three-stage process in the move toward EMU. In Stage I, the original twelve EC members agreed to abide by an exchange-rate mech-

---

rameter estimates are reported within parentheses.) The results are virtually identical to those obtained by Soskice:

$$\underset{}{\text{AVEUE}} = \underset{(1.649)}{6.623} - \underset{(.346)}{.908} \times \text{CWB} \qquad \text{Adj. } R^2 = .357$$

The effect of CWB on unemployment remains significant even after we control for the possible effect of central bank independence (CBIND = 4, if the bank is viewed as very independent, ranging to CBIND = 1, if not independent), often argued to be a crucial factor in Germany's labor market performance. The regression of AVEUE on CWB and CBIND shows CWB to continue to be an important determinant of unemployment, while CBIND has no statistically significant effect on AVEUE. (Again, standard errors of parameter estimates are reported within parentheses.)

$$\text{AVEUE} = \underset{(1.649)}{6.897} - \underset{(.449)}{.773} \times \text{CWB} - \underset{(.702)}{.364} \times \text{CBIND} \qquad \text{Adj. } R^2 = .357$$

These results are confirmed using the full Soskice sample, adding the United States (0; 4.1) and Japan (5; 4.9) to the European sample:

$$\text{AVEUE} = \underset{(1.429)}{6.882} - \underset{(.256)}{.838} \times \text{CWB} - \underset{(.580)}{.288} \times \text{CBIND} \qquad \text{Adj. } R^2 = .525$$

[15]Freeman (1989) presents evidence showing a negative correlation between country size and coordinated wage bargaining that indirectly suggests Coasian agreements between the labor and employer groups in the larger EC may be more difficult.

anism created as part of the European Monetary System. Capital and exchange controls among Member States were largely eliminated. During Stage II, to be completed by January 1994, capital and exchange controls would be further reduced, and the current Council of Central Bank Governors would be replaced by the new European Monetary Institute. Finally, in Stage III, optimistically to be completed by January 1, 1999, the European Monetary Institute would be replaced by the European Central Bank.

The political structures of the EC and of EMU seem especially complex. Garrett (1992) provides a useful overview. While there is no formal EC constitution, the legal system in the EC treats the 1958 Treaty of Rome and the Single European Act like a constitution.[16] The European Parliament is constituted similarly to the U.S. House of Representatives. Its 518 members are elected, each representing citizens of one of the EC Member States. At the moment, however, the most important institution in deciding issues relating to the EC economic affairs is the European Council of Ministers. The Council of Ministers is composed of representatives from each of twelve EC countries. Voting is weighted, with Great Britain, France, Germany, and Italy having ten votes, Spain eight, five each for Belgium, Greece, the Netherlands, and Portugal; three for Denmark and Ireland, and two for Luxembourg. Fifty-four of the seventy-six votes constitutes a qualified majority.[17] Finally, a European Court of Justice performs a monitoring function, much as a U.S. Federal Court would monitor an administrative agency.[18]

At this time, it is not entirely clear which political body—the Council of Ministers or the Parliament—will have primary responsibility for managing a centralized fiscal policy.[19] Current rules favor the Council of Ministers. While formal power over fiscal policy is granted by Article 103 of the Maastricht Treaty to the heads of state from each EC country meeting as a body called the European Council, this body receives its agenda from the Council of Ministers. The Council of Ministers drafts guidelines for the economic policies of member countries and reports its findings to the European Council. In addition, the Council of Ministers can monitor economic conditions (by Article 104c) and policies in individual countries and make recommendations to national governments.[20] If the Council of Ministers' recommendations are not heeded,

[16]Garrett (1992, p. 535). See also Garrett (1993).

[17]Not all issues within the COM are decided by qualified majority voting; some require unanimity. On which basis fiscal decisions would be made remains open to question at this time.

[18]For a complete characterization of the structure of the process by which economic rules are implemented in the EC, see Garrett (1992, Fig. 5, p. 554).

[19]In contrast, the management of monetary policy is clearly articulated. The EMU will be run by the Executive Board of the European Central Bank (consulting with the governors and the heads of states) and the (twelve) national central bank governors, with decisions made by simple majority. Indirectly, the European Central Bank (ECB) will have limited coercive powers: It can undertake financial surveillance and regulation. Its primary goal will be price stability, but its ability to achieve that goal will depend on national governments engaging in sound fiscal policies. Otherwise, the ECB's ability to serve as a lender of last resort in the face of liquidity crises will be threatened.

[20]Article 104c of Maastricht states in addition that the European Commission is responsible for monitoring fiscal developments in member states to determine their compliance with the reference values in the Protocol on the Excessive Deficit Procedure (which sets goals for national deficits). This protocol is currently applied quite flexibly, which makes its impact relatively small. See Fratianni, von Hagen, and Waller (1992) for details.

Eichengreen (1992, p. 29) points out many of the loopholes in Article 104 of Maastricht. The United States provides an interesting comparison in this respect. In the United States, forty-six states have balanced-budget requirements while thirty states limit the power to raise debt. There is some evidence that these constraints have had some effect, but we suspect that the effect has not been substantial; see Eichengreen (1992) and Gramlich (1987). Monitoring of debt limits and credit circumstances is difficult; agency problems abound.

the Council can impose sanctions: It can have the European Investment Bank halt lending to the country at issue, it can require non-interest-bearing deposits with the Community, and it can impose fines.

The continued institutional preeminence of the Council of Ministers is not certain, however. If EC fiscal policy becomes important and Community legislation is required for implementation, the European Parliament assumes a more central role in the policy process. Through a process called the *Cooperation Procedure* the Parliament has the ability to first comment on and to then approve, amend, or reject Council legislation; see Nugent (1991, Chapter 10). The Council is then given the opportunity to override the Parliament's amendments or rejections, but the override requires unanimity of the Council, not just a qualified majority. As the fiscal agenda of the EC grows with the development of the EMU, so too should the influence of Parliament over domestic fiscal policy.[21]

B. The Politics of Fiscal Policy and the EC Agenda

Expanding centralized fiscal authority within the EC requires a careful consideration of the nature and performance of the EC's political institutions that will be assigned this added responsibility. As the new political economy has made clear, there is no guarantee that majority rule—or qualified majority rule—legislatures will allocate public resources efficiently. The recent U.S. experience is instructive on this point.

In the United States, central government fiscal policy originates with the Congress, a two-chamber legislature composed of a House of 435 locally elected representatives and a 100-member Senate consisting of two state-elected senators from each of the fifty states. Decision-making in each of the legislative bodies resides in committees, and each committee has strong influence over its assigned domain of policy. There are tax committees (Ways and Means, and Finance), spending committees (Appropriations), and numerous policy committees. Evidence suggests that legislators request, and are assigned to, those legislative committees whose policy domain is most central to the interests of their constituents. Once on the committee, they seek policies that benefit the "folks back home," typically, localized public goods or transfers, e.g., a farm subsidy, a city renewal project, or a favorable trade regulation for the dominant local industry. Unfortunately, what pays for such local goods and transfers are national taxes assessed on residents outside the benefiting state or local district. The incentives here are clear. When local benefits are paid for through national taxes, local constituents and their legislative representatives will demand more than the socially efficient level of the public good or transfer. Studies of U.S. congressional budgeting suggest that in recent years the economic inefficiency from such a legislative process may be as high as $.15 for each dollar spent by the central government on localized public goods and transfers.[22]

---

[21]See Tsebelis (1992), who suggests that this agenda-setting influence of the Parliament has been understated. Further, if the proposed "Co-decision" Procedure of the Maastricht Treaty (based on Section 189b) were to replace the current "Cooperation" Procedure that presently governs internal market policy-making, then the Parliament would obtain not just agenda power but also veto power over Council policies.

[22]In effect, the politics of the U.S. Congress turns targeted policies with specific objectives into equalization grants giving benefits to all congressional districts. This transformation would prove particularly damaging for unemployment insurance programs designed to offset the adverse consequences of country-specific, asymmetric demand shocks.

In the simplest case, unemployment programs would distribute aid dollars according to the formula: $\text{Aid}_i = \alpha + \beta^* [\text{UE}_i - \eta]$, where α and β are program parameters, UE_i is country i's unemployment rate, and η is the EC-wide natural rate of unemployment. The constant term α is the program's equalization component, while the slope pa-

There are two solutions to this problem. The first is simply to exclude significant fiscal policy from the domain of responsibility of the central government.[23] Such an approach may give away too much. One would hope that a second strategy that seeks to improve the allocative performance of majority-rule legislatures might be fashioned. Again, understanding the U.S. congressional experience is helpful, for in periods of strong party rule or with strong presidential leadership, the propensity of the U.S. Congress to adopt inefficient fiscal policies was significantly curtailed.[24] Such results make sense, for centralizing institutions such as political parties and the president are exactly what is needed to control individual legislators' incentives to overspend.

Fortunately, the current EC political structure through the Council of Ministers offers such a centralizing institution for the control of EC fiscal policies. This relatively small legislative body is likely to be tied closely to country, rather than localized, political interests, thereby muting the incentives to overprovide public goods and transfers. While individual countries retain some incentive to overspend on country-specific public goods using an EC-wide tax base, the bias here will be far less than anything now existing in the U.S. Congress or that might hold in the European Parliament. Further, the weighted voting of the Council favors the larger and wealthier countries of the EC, enhancing their ability to resist subsidized and inefficient overspending. For fiscal efficiency, this is as it should be, for the larger and wealthier countries will bear a disproportionate share of any EC-wide taxes.

The preeminence of the Council of Ministers in fiscal affairs would give way, however, if the newly proposed "Co-decision" Procedure of the Maastricht Treaty (based on Section 189b) were used instead of the current "Cooperation" Procedure that presently governs the internal market. Under the Co-decision Procedure, the European Parliament will be given a veto power over Council policies. As a large and decentralized political body, Parliament's incentives for the formation of fiscal policy will eventually, we conjecture, closely mimic those now found in the U.S. Congress.[25] The Council will have to be responsive to those preferences when shaping fiscal policy, for under the Co-decision Procedure its powers are limited to being the agenda setter to a decentralized legislature.[26] Alternative policies must be tried until one such

rameter β is the program's insurance component. Negative Aid_i would be a tax payment into the system if the country's economy experienced a temporary positive shock to demand and UE_i fell below η. Decentralized legislatures act to lower β, reducing insurance, so as to raise α, giving more to everyone. See Inman (1988) for evidence on this point.

[23]A more finely tuned prohibition might be suggested, one that limits the central government to those fiscal policies that are truly "national" public goods. Unfortunately, the enforcement of such a regulation is difficult if not impossible. Certainly the legislature cannot be given this responsibility; it is a simple matter to define each local public good as "in the national interest." For example, limiting the central government to the task of providing unemployment insurance opens the door to all kinds of local subsidies defined by the legislature as protection against macroeconomic swings.

The task of regulating the legislature should go to an outside monitor such as the courts. Unfortunately, even here clear regulations of the central government legislature may not be possible; for a description of the failed U.S. experience to regulate central government intrusions into local policy domains, see Merritt (1988).

[24]Again, see Inman and Fitts (1990).

[25]At the moment, Parliament acts more or less as a cohesive unit (due to the constituency of the Christian Democrats). See Inman and Rubinfeld (1992a) for more on the politics of the U.S. Congress.

[26]The co-decision process adds another hurdle to any positive action by the Council of Ministers and the Parliament. This could increase the discretionary power of the European Court to interpret existing legislation. Furthermore, the advantages of qualified majority voting as used by the Council of Ministers will be dampened somewhat by the bicameral nature of the co-decision process. This point is developed in Cooter and Drexl (1993).

policy meets the needs of at least 51% of the Parliament. Not surprisingly, the added influence of the decentralized Parliament under the Co-decision Procedure is likely to make fiscal policies less efficient.[27] Still, such diminished Council powers are strongly preferred to no Council powers at all and the complete dominance of Parliament over fiscal affairs.[28]

To the extent, then, that EC fiscal policy remains the legislative responsibility solely of the Council of Ministers—or even, if modified to agenda power only—we are optimistic that such policies can be fashioned to minimize the excesses of more decentralized legislative processes. High on the Council's agenda should be policies to insure against temporary unemployment. To the extent that the Parliament alone assumes responsibility for EC fiscal policies, we would become significantly more cautious in our recommendations. In this instance, the costs of centralization may significantly outweigh the benefits in the provision of fiscal policy.

IV. Implications for European Federalism

The adoption of the EMU raises important—and as yet not carefully considered—issues of economic federalism. If adopted, the EMU will deny members of the EC access to country-specific monetary policies to soften the consequences of adverse country-specific economic shocks. Member States can look to own managed fiscal policies as an alternative policy tool, but such deficit policies are likely to be ineffective for smaller members and perhaps the source of adverse negative externalities for all Community members if adopted by the larger countries of the EC. A centralized, EC-wide fiscal strategy of insurance against negative demand shocks is an attractive alternative, run either as experience-rated transfers and taxes to countries or as experience-rated unemployment insurance for individuals. Both options will require the implementation of significant EC-wide taxes and transfers, however. Now consideration must be given to the ability of central government fiscal institutions to efficiently manage such a program. A centralized political process with legislative power concentrated in the hands of the Council of Ministers is the most promising of the current EC alternatives.

Our analysis here has implications that go beyond questions relating to just the joint management of monetary and fiscal federalism. Many of the same concerns and lines of thought apply to economic federalism in the EC more generally.[29] The EC has struggled with the meaning of economic federalism since the signing of the Maastricht

---

[27]See Baron (1993).

[28]The Council might relate to the European Parliament much as in the United States the House Appropriations or Ways and Means Committees relate to the U.S. House of Representatives. For a more detailed analysis of EC decision making, see Biehl (1990), Nugent (1991), Peters (1992), Sandholtz (1993), and Wessels (1991).

[29]While our mode of federalism analysis can be applied equally as well to the United States or the EC, there are a number of important structural differences that may lead to different conclusions about the desirability of centralization. First, the U.S. federalist system relies on constitutional principles of sovereignty and separation of powers. Because states have residual powers under the U.S. Constitution, Congress must expressly authorize a federal regulatory role, unless interstate commerce is involved. In addition, the U.S. Congress cannot directly regulate state activities; while the Congress can subsidize state programs, it cannot mandate that the states put regulatory programs into place. In contrast, in the EC there is no constitution, and EC law has dominance over national laws. The EC cannot only subsidize the regulatory activity of Member States, it can mandate that states put regulatory programs into place. Whether the EC power to regulate will or should lead to a substantially increased regulatory centralization remains an unanswered question at this time.

Treaty. The focus has been on the principle of "subsidiarity," which would determine which economic functions should be kept solely at the state or country levels.[30] Further, there remains substantial debate as to which economic functions the principle of subsidiarity applies. Toth (1992) suggests that the only role left to the Member States is environmental policy. However, in education, vocational training, youth, culture, and public health, EC action should be restricted to "encouraging cooperation between Member States and, if necessary, . . . supporting and supplementing their action." The Commission of the European Communities Report (1977) suggests that education, health, housing, and social security should remain with Member States, primarily because there are relatively few spillovers.

When considering the question of whether EC economic functions ought to be centralized, our analysis recommends that we begin by asking whether decentralized domestic economic policies generate substantial spillovers. If the answer is yes, we then ask whether market mechanisms or coordinated Coasian solutions are possible to overcome those spillovers. Only if this answer is no, do we pursue the centralization of economic policy further. Third, and finally, before accepting centralization, we must evaluate the political process by which centralized decisions are made. Can a central government political institution be created that will implement more efficient economic policies? If yes, then and only then do we favor centralization. It is in answering these three questions that the principle of subsidiarity becomes operational.

References

ALESINA, ALBERTO AND LAWRENCE SUMMERS (1993), "Central Bank Independence and Macroeconomic Performance," *Journal of Money, Credit, and Banking*, 25, 2, May, pp. 151–162.

BARON, DAVID P. (1993), "A Theory of Collective Choice for Government Programs," Research Paper No. 1240, Graduate School of Business, Stanford University.

BAYOUMI, TAMIM AND BARRY EICHENGREEN (1993), "Shocking Aspects of European Monetary Unification," in Francesco Giavazzi and Francisco Torres, eds., *The Transition to Economic and Monetary Union in Europe*, Cambridge and New York: Cambridge University Press.

BAYOUMI, TAMIM AND PAUL MASSON (1991), "Fiscal Flows in the United States and Canada: Lessons for Monetary Union in Europe," International Monetary Fund.

BIEHL, DIETER (1990), "Deficiencies and Reform Possibilities of the EC Fiscal Constitution," in *The Politics of 1992*, Cambridge: Basil-Blackwood, pp. 85–99.

BLANCHARD, OLIVIER AND LAWRENCE KATZ (1992), "Regional Evolutions," *Brookings Papers on Economic Activity*, 1, pp. 1–61.

BRUNO, MICHAEL AND JEFFREY SACHS (1985), *The Economics of Worldwide Stagflation*, Cambridge, MA: Harvard University Press.

BUITER, WILLEM AND KENNETH KLETZER (1990), "Reflections on the Fiscal Implications of a Common Currency," Working Paper No. 418, Centre for Economic Policy Research, May.

CALMFORS, LARS AND JOHN DRIFFILL (1989), "Bargaining Structure, Corporatism and Macroeconomic Performance," *Economic Policy*, 3, pp. 13–61.

CANZONERI, MATTHEW AND BEHZAD DIBA (1991), "Fiscal Deficits, Financial Integration, and a Central Bank for Europe," *Journal of the Japanese and International Economies*, 5, 4, December, pp. 381–403.

[30]Thus, Title II of Maastricht (inserting Article 3b into the EEC Treaty) states, "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 in so far 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." See Majone (1992).

Commission of the European Communities (1977), *McDougall Report of the Study Group on the Role of Public Finance in European Integration*, Luxembourg: Office for Official Publications of the EC.

Commission of the European Communities (1990), "One Market, One Money: An Evaluation of the Potential Benefits and Costs of Forming an Economic and Monetary Union," *European Economy* 44, October, Luxembourg.

Committee for the Study of Economic and Monetary Union [Delors Report] (1989), *Report on Economic and Monetary Union in the European Community*, Luxembourg: OOPEC.

Cooter, Robert and Josef Drexl (1993), "The Local of Power in the Emerging European Constitution: Winners and Losers under the Maastricht Treaty," draft, June.

De Grauwe, Paul (1992), *The Economics of Monetary Integration*, Oxford: Oxford University Press.

Eichengreen, Barry (1990a), "Currency Union," *Brookings Papers on Economic Activity*, April, pp. 118–187.

Eichengreen, Barry (1990b), "One Money for Europe,? Lessons from the U.S. Currency and Customs Union," *Economic Policy*, 10, April, pp. 117–187.

Eichengreen, Barry (1991), "Is Europe an Optimum Currency Area?" Working Paper No. 3579, National Bureau of Economic Research, January.

Eichengreen, Barry (1992), "Should the Maastricht Treaty Be Saved?" In *Princeton Studies in International Finance*, No. 74, December, International Finance Section, Dept. of Economics, Princeton University.

Eichengreen, Barry (1993a), "Labor Markets and European Monetary Unification," in Paul Masson and Mark Taylor, eds., *Policy Issues in the Operation of Currency Unions*, Cambridge and New York: Cambridge University Press, forthcoming.

Eichengreen, Barry (1993b), "European Monetary Unification," *Journal of Economic Literature*, September, pp. 1321–1357.

Eichengreen, Barry and Jeffrey Frieden (1993), "The Political Economy of European Monetary Unification," *Economics and Politics*, forthcoming.

Eichengreen, Barry and Charles Wyplosz (1993), "The Unstable EMS," draft, March, prepared for the Brookings Panel on Economic Activity.

Emerson, Michael et al. (1988), "The Economics of 1992," Commission of the European Communities, *European Economy*, 35, March, special issue.

Fratianni, Michele, Jurgen von Hagen and Christopher Waller (1992), "The Maastricht Way to EMU," in *Essays in International Finance*, No. 187, June, Dept. of Economics, Princeton University.

Freeman, Richard (1989), "Labour Market Institutions and Economic Performance," *Economic Policy*, 3, pp. 64–80.

Garrett, Geoffrey (1992), "International Cooperation and Institutional Choice: The European Community's Internal Market," *International Organization*, 46, 2, Spring, pp. 531–560.

Garrett, Geoffrey (1993), "The Politics of Maastricht," *Economics and Politics*, July, pp. 105–124.

Gramlich, Edward M. (1987), "Subnational Fiscal Policy," in *Perspectives on Local Public Finance and Public Policy*, 3, pp. 3–27, JAI Press.

Gros, Daniel and Niels Thygesen (1992), *European Monetary Integration: From the European Monetary System to European Monetary Union*, London: Longman.

Inman, Robert (1988), "Federal Assistance and Local Services in the United States: The Evolution of a New Federalist Fiscal Order," in H. Rosen, ed., *Fiscal Federalism*, Chicago: University of Chicago Press, pp. 33–74.

Inman, Robert P. and Michael A. Fitts (1990), "Political Institutions and Fiscal Policy: Evidence from the U.S. Historical Record," *Journal of Law, Economics, and Organization*, 6, pp. 79–132.

Inman, Robert P. and Daniel L. Rubinfeld (1992a), "Fiscal Federalism in Europe," *European Economic Review*, 46, pp. 654–660.

Inman, Robert P. and Daniel L. Rubinfeld (1992b), "Can We Decentralize Our Unemployment Policies? Evidence from the United States," paper presented at the International Seminar on Public Economics, Tokyo, Japan, August.

Majone, G. (1992), "Regulatory Federalism in the European Community," *Environment and Planning: Government and Policy*, 10, pp. 299–316 (Dept. of Political and Social Science, European University Institute, I-50100 Florence, Italy).

Merritt, Deborah Jones (1988), "The Guarantee Clause and State Autonomy: Federalism for a Third Century," *Columbia Law Review*, 88, 1, pp. 1–74.

NUGENT, NEILL (1991), *The Government and Politics of the European Community*, 2nd Ed., Durham, NC: Duke University Press.

PETERS, GUY (1992), "Bureaucratic Politics and the Institutions of the European Community," in Alberta M. Sbragia, ed., *Europolitics*, Washington, DC: Brookings Institution, pp. 75–122.

SACHS, JEFFREY AND XAVIER SALA-I-MARTIN (1992), "Federal Fiscal Policy and Optimum Currency Areas: Evidence for Europe from the United States," in Matthew B. Canzoneri, Vittorio Grilli, and Paul R. Masson, eds., *Establishing a Central Bank: Issues in Europe and Lessons from the U.S.*, Cambridge: Cambridge University Press.

SANDHOLTZ, WAYNE (1993), "Choosing Union: Monetary Politics and Maastricht," *International Organization*, 47, 1, Winter, pp. 1–39.

SIBERT, ANNE (1991), "Public Finance and Coordination Problems in a Common Currency Area," draft, June.

SOSKICE, DAVID (1990), "Wage Determination: The Changing Role of Institutions in Advanced Industrialised Countries," *Oxford Review of Economic Policy*, 6, 4, pp. 36–61.

THYGESEN, NIELS (1994), "Why Is Economic and Monetary Union an Important Objective for Europe?," in this issue.

TOTH, A. G. (1992), "The Principle of Subsidiarity in the Maastricht Treaty," *Common Market Law Review*, 29, pp. 1079–1105.

TSEBELIS, GEORGE (1992), "The Power of the European Parliament as a Conditional Agenda Setter," draft, UCLA and the Hoover Institution.

WESSELS, WOLFGANG (1991), "The EC Council: The Community's Decisionmaking Center," in Robert O. Keohane and Stanley Hoffman, eds., *The New European Community*, Boulder, CO: Westview Press, pp. 133–154.