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# The role of regional, national and EU budgets in the Economic and Monetary Union



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Introduction

Ladies and gentlemen,

Let me first stress that it is a great pleasure to take part in this event that promotes political dialogue between the European institutions and the associations representing the municipalities, the provinces and the regions of Member States.

I would also like to congratulate the Committee of the Regions for its initiative in organising this meeting. I consider this structured dialogue a very useful and timely opportunity to reinforce the relationship between the European Commission and the local and regional authorities of the EU. Such a constructive exchange of views and experiences allows not only for the dissemination of EU policies and activities but also bringing the institutions of the Union closer to citizens.

The topic I will address today represents one aspect of the current EU economic policy making. Devising an appropriate fiscal policy and building a strong institutional framework behind its implementation are key elements to fostering economic and political stability as well as sound and sustainable economic growth in Europe. In this respect, regional and local representatives may bring new and relevant arguments in terms of policy experiences.

## The consequences that the reshaping of budgetary competencies has for the conduct of fiscal policy in EMU

In the last decade, the management of public finances in EU countries has simultaneously been affected by two major changes in the economic and institutional setting. The first is a deeper European integration. This has notably given rise to the formation of an economic and monetary union, and entailed the enlargement of the EU to include ten new Member States. The second refers to the decentralisation process that a majority of EU Member States have witnessed, and that implies greater legislative and fiscal jurisdictional powers for regional and local governments.

On the one hand, the creation of EMU called for the establishment of budgetary coordination mechanisms among its members, given that the consequences of unsound fiscal policies in one country would be shared by the others. The provisions of the Stability and Growth Pact (SGP) establish a preventive surveillance to avoid excessive deficits, and precise action if necessary to correct them. This then forms the basis of the EU fiscal framework and has important consequences for the conduct of fiscal policy in terms of budgetary discipline.

On the other hand, the reshaping of national budgetary competencies within Member States has not only affected the conduct of fiscal policy domestically through a greater decentralisation of public finances. It has also implied significant repercussions in relation to the fiscal requirements at EU level. Specifically, the Treaty and the SGP obligations concern the general government as a whole, that is, central, regional and local governments plus the social security sub-sector. In the reshaped national institutional background, the capacity of territorial governments to comply with the SGP provisions has increased considerably.

Apart from cultural and historical country-specific elements, these fiscal decentralization processes may be partly justified on economic grounds. In particular, lower general government tiers may better tailor the provision of public goods and services to local needs and preferences. They may also establish a link between their provision and their financing, thereby increasing accountability at regional and local level.

Overall, Member States are characterized by a large variety of political settings and intergovernmental relationships, which in turn cause significant differences in the way budgetary responsibilities are assigned between levels of government. The allocation of functions for territorial governments, their expenditure composition and their means of financing are far from being homogeneous in Member States. However, a clear trend emerges showing that fiscal decentralisation has gained strength since the early 90s. Moreover, this process is still on the political agenda in a significant number of Member States and further changes are likely in the future.

Given this trend -in the context of EMU-, the following question appears of utmost importance: How are these processes of fiscal decentralization affecting compliance with the deficit and debt requirements enshrined in the Treaty and the SGP? The answer to this question requires an analysis into whether a link exists between the degree of fiscal decentralisation and Member States' budgetary performance.

Some economic policy analysts and academics argue that delegation of fiscal powers to lower levels of government may weaken budgetary discipline. The reason is that central authorities may encounter difficulties in controlling the fiscal decisions of sub-national politically elected bodies.

In addition, fiscal decentralisation in most Member States has been more pronounced on the expenditure side than on the revenue side. This is in line with the strong arguments provided by the theory of fiscal federalism in favour of a centralised tax collection. Centralised revenue management could lower the costs of collection and compliance due to economies of scale. It could also more efficiently prevent tax evasion induced by mobile tax bases and avoid an excessive tax competition.

However, as expenditure powers of territorial entities are enhanced, the asymmetry between spending and revenue decentralisation can give rise to the so-called "vertical fiscal imbalance". In this scenario, sub-national governments tend to rely increasingly on transfers from central government to finance their expenditure. These transfers and grants may create the perception that local public spending is funded by non-residents, weakening spending discipline and public policy-cost awareness. This situation could push demand for regional and local public expenditure above optimal levels. The pressure for increased transfers from central to sub-central authorities can eventually translate into higher deficits and debt of the whole general government sector that in turn risk jeopardising the respect of the SGP provisions.

What does evidence tell us? Are these pessimistic views being substantiated in the EMU context?

At first glance, there does not appear to be a strong link between the degree of fiscal decentralisation and fiscal performance of EU countries. At present, regional and local governments in a majority of Member States show balanced budgets or run small deficits regardless of their territorial organisation. The major exception is Germany, where territorial governments account for a substantial part of the general government deficit. Nevertheless, in most Member States spending pressures arising from lower tiers of government do not seem to have been translated into higher deficits at central level through increased transfers.

Looking forward, how could the process of fiscal decentralisation affect budgetary discipline?

The continuation of this decentralisation trend is taking place in politically sensitive areas of public spending, such as health, education and social welfare that could increase the magnitude of the existing "vertical fiscal imbalances" and hence negatively affect the overall budgetary discipline of the general government. Specific territorial taxes accompanied by an adequate system of transfers from central authorities can function satisfactorily in a context of limited spending decentralization. In contrast, when expenditure decentralisation grows above certain thresholds and is linked to important spending functions like health, education and social welfare, regional and local spending should be financed by solid tax bases, such as income taxes and the VAT.

However, the degree of tax autonomy that can be offered to territorial governments on these tax bases appears limited. The VAT is subject to EU regulations while territorial competencies on income tax rates should be applied carefully in order to avoid tax competition among jurisdictions, inefficient labour allocation and a weakening in the redistributive role that this tax instrument plays in a majority of EU countries.

Current developments in EU countries point to a more intensive use of tax-sharing schemes, with a very limited tax autonomy. Yet, extending the use of tax sharing for financing regional and local entities is problematic in several aspects. It may weaken the perceived link between expenditure and financing at territorial level. In addition, the revenues of lower levels of government are more dependent on choices made by a higher government tier, thereby reducing accountability. Furthermore, tax sharing mechanisms based on VAT or income taxes could introduce a pro-cyclical bias in the conduct of regional and local fiscal policy.

What options then are available to support fiscal decentralisation while ensuring overall budgetary stability and the respect of the SGP provisions?

The problems linked to intergovernmental relationships are so complex and country-specific that there are no general panacea as a solution. However, some reasonable suggestions can be made in light of the previous arguments.

Firstly, a wider flexibility for territorial governments in the management of their own resources, including a reasonable degree of tax autonomy, could be useful to tackle possible vertical fiscal imbalances and their associated adverse effects. An appropriate coordination among different levels of governments and within sub-national tiers when they have been assigned tax-setting powers could significantly dampen down possible harmful effects in terms of fiscal competition or inefficient resource allocation. The so-called national stability pacts, to which I will refer later, may contribute positively to foster this coordination. Further innovations in the design of some taxes, for instance taxes on goods and services, may also help increase this tax autonomy.

Secondly, transparent and objective rules for determining transfers and tax-sharing schemes to regional and local authorities may help reinforce an appropriate conduct of budgetary policy at sub-national level. Experiences at national level show that the financial stability of public finances managed by the lower government tiers largely depends upon the existence of consensual relationships between all the institutional actors concerned. In my view, this requires that transfers and tax-sharing mechanisms applied to territorial governments stem from clear-cut and fully understandable rules. This in turn should be perceived as a "fair institutional setting" by regional and local authorities.

Finally, well-designed numerical fiscal rules establishing limits for expenditure, deficit and/or debt may suitably complement the two previous requirements. This should ensure budgetary stability at sub-national level and contribute to the respect of the SGP provisions for the whole general government sector. Again, national stability pacts may provide an appropriate framework to provide a consensual approach in the implementation of these fiscal rules while allowing the use of economic judgement when assessing their respect.

## National fiscal frameworks and EMU requirements

Against this background, let me now turn to the role that national fiscal frameworks can play in ensuring compliance of national budgetary policies with EMU requirements.

In the last decade, a number of Member States have reconsidered their fiscal relations across different levels of government by taking into account the need to comply with the EU budgetary requirements. Apart from the need to cope with growing fiscal decentralisation, the coordination mechanisms at national level implemented since the second half of the 90s, have also sought to deal with the vertical institutional imbalance implied by the budgetary obligations stemming from the Treaty. These concern the outcomes of the general government as a whole (including therefore both central and territorial governments), but leave the responsibility for compliance with the central government. However, it is evident that compliance with EMU requirements depends on the budgetary performance of all government tiers.

Obviously, this institutional imbalance is more important in those countries enjoying a higher fiscal decentralisation and, in particular, in some federal or quasi federal Member States. This situation led some Member States to redefine their national fiscal frameworks through two different approaches that form the basis of the so-called internal or national stability pacts. Thus, some countries such as Austria, Belgium and Germany have adopted a cooperative approach that seeks to reach an agreement on the fiscal targets assigned to each level of government in order to ensure the respect of the SGP. In other cases, for instance Spain and Italy, the strategy implemented relies more on the existence of fiscal rules which impose binding constraints on budgetary developments with a view to ensuring consistency with EMU requirements.

These two approaches are not mutually exclusive but rather complementary and, in fact, all national fiscal frameworks currently in place in EU Member States combine features of both.

The existing national stability pacts vary widely in terms of target-setting, legal status, monitoring and enforcement mechanisms.

These differences largely reflect historical circumstances, territorial and institutional structure and diversity in budgetary process. Some arrangements have partially replicated the medium-term objective of the SGP of close to balance or in surplus at territorial level, while others define budgetary targets on a yearly basis. In some cases, these arrangements are enshrined in law whereas in others they are formulated on the basis of an inter-institutional agreement between layers of government. Finally, there are also important differences regarding the way they are implemented and monitored and the possible enforcement mechanisms in case of non-compliance.

Despite the diverse nature of the existing national stability pacts, some general indications can be drawn.

Firstly, the monitoring of budgetary developments within these internal pacts could be significantly improved by setting up an independent authority in charge of this task. In the same vein, the quality and availability of relevant data currently represents one of the major obstacles to making an accurate assessment of the conduct of budgetary policy at lower levels of government. The improvement of these statistical aspects is therefore also of paramount importance.

Secondly, there are difficulties in effectively implementing those enforcement mechanisms and sanctions foreseen in some national stability pacts in case of non-compliance. This is partly caused by the vague definition of these mechanisms, which increases the chances for circumvention. In addition, unanimity of all levels of governments concerned by the pact is generally required to make possible any corrective measure or sanctions.

In spite of these weaknesses, the overall functioning of the national stability pacts can be considered broadly satisfactory in terms of budgetary outcomes for a majority of those Member States that have implemented these arrangements. Experiences in Belgium, Spain and Austria point to this positive assessment. In all these countries, national stability pacts have played an important role in sustaining the respect of the SGP.

In these cases, the main focus has been placed on effective and efficient intergovernmental procedures for consultation and cooperation among government tiers, rather than monitoring and enforcement mechanisms. This cooperation seems to have been able to solve problems at an early stage, thereby ensuring the achievement of sound public finances. Thus empirical evidence appears to favour a consensual approach for intergovernmental relationships and support procedures fostering dialogue between central and territorial governments.

However, these policy implications do not exclude the implementation of fiscal rules and other budgetary instruments to reinforce and complement fiscal governance for sub-national tiers. Constraints on the deficit and debt of lower levels of government help to establish clear and understandable "rules of game", on which the required dialogue among national and sub-national authorities can be established.

Finally, other instruments for an adequate budgetary planning should also be considered in the design of national stability pacts. In particular, budgetary multi-annual frameworks for monitoring and assessing compliance of the rules and for better taking into account the effect of the business cycle appear appropriate. This is very much in line with the preventive part of Stability and Growth Pact, which through medium-term programmes encourages member states to focus more on both the quality and sustainability of public finances.

## Conclusions

To conclude, let me stress once more the importance of fiscal governance at all levels of government. Appropriate national fiscal frameworks based on stable territorial and intergovernmental structures are key elements to support the conduct of sound fiscal policies. This is crucial given the latter are an essential component of the framework of economic politics established within EMU to deliver stability and growth.

Of course, there are no simple recipes that work for any country at any period. Nevertheless some common principles are available, and it would important to keep them in mind when countries look to establish their national fiscal framework on the basis of their own institutional context and the nature of their budgetary problems. Let me stress nonetheless how critical it is that progress in this field matches the process of institutional decentralisation.

Thank you for your attention.