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Multi-level governance in fiscal consolidation and stabilisation

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Economists discuss multi-level governance in terms of *fiscal federalism*, namely as a problem of assigning fiscal functions optimally to different tiers of government. This literature assumes that the jurisdiction of the monetary authority coincides with that of the central fiscal authority. However, EMU implied for each member state that national fiscal policy became devolved relative to supranational monetary policy. In several member states, this ‘upward’ devolution of stabilisation came on top of fiscal decentralisation in the conventional sense. In the run-up to EMU, and even earlier, governments tended to decentralise public finances. The question this paper asks is how this dual trend of devolution relates to the goals of the EMU fiscal framework and its operation in practice. In this paper, we argue that *laboratory fiscal federalism* is a more appropriate framework than functional public finance or constitutional public choice for understanding fiscal devolution in EMU. We explore to what extent national governments have used innovations in upward and downward devolution to get better control over their budgets, using EMU as a lever. We also ask what this potential gain in budgetary control and consolidation has meant for national stabilisation in EMU.

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A. Introduction: The puzzles of devolved fiscal governance in EMU

Economists discuss multi-level governance in terms of *fiscal federalism*, namely as a problem of assigning the fiscal functions of stabilisation, redistribution and Pareto-superior allocation optimally to different tiers of government (Oates 1999). This approach treats fiscal decentralization as a matter of economic constitution or governance and not merely as a matter of financial contracting.¹ Assuming that the jurisdiction of the monetary authority coincides with that of the central fiscal authority, the stabilisation function is assigned to the centre. However, the European monetary union implied for each member state that national fiscal policy became devolved relative to supranational monetary policy, raising the question of how stabilisation should be assigned. A potential problem of economic governance in EMU is that there is no mechanism for determining the aggregate fiscal stance and no way of coordinating this fiscal stance with monetary policy. This has been noted by macroeconomists for a long time; and is typically diagnosed as a symptom of the deficiencies in political integration (e.g. De Grauwe 2006).

Furthermore, in several member states, this ‘upward’ devolution of stabilisation relative to monetary policy came on top of fiscal devolution in the conventional, downward sense.² Ever since the 1980s, governments have tended to decentralise public finances, ie devolve tax or spending powers to sub-national governments (Darby et al 2003; Bordignon 2006: 128-130; Keating 2007: 18). It is difficult to maintain that this problem arises because of a lack of political integration although it equally raises the problem of how stabilisation function should be assigned³. The trend towards downward devolution has attracted the interest of scholars in fiscal federalism who have examined the incentives that politically driven assignments give to the various tiers of government to fulfil the three fiscal functions. Of particular interest in this context is the interaction between fiscal decentralisation and the maintenance of fiscal sustainability (Journard and Kongsrud 2003, Darby et al 2004). This line of research has found that devolution has a rather ambiguous and often detrimental effect on budgetary consolidation.

The overall question this paper tries to answer then is how this dual trend of devolution, downwards and upwards (Bordignon 2006: 110), relates to the goals of the EMU fiscal framework and its operation in practice; a framework that tries to tie governments’ hands with respect to discretionary stabilisation and to steer their hands with respect to national budgetary consolidation. In order to answer this question, we argue that *laboratory fiscal*

¹ This alternative of treating fiscal relationships among government levels as analogous to contracts in the finance literature is arguably more ‘modern’ because it uses the microeconomic machinery of principal-agent models. Wildasin (1997, 2004) is a pioneer of this approach. Bordignon (2006: 118-121) links the two literatures, stressing the relevance of the fiscal federalism framework.

² This impact on devolution is specific to the stabilisation function, in political terms European integration induces recentralisation at the national level as Keating (2007: 15) points out: “The first [effect] was a recentralisation as matters of regional competence were transferred to Europe. Since states tended to view European policy as a matter of foreign affairs, these competences were brought into the reserved domain of the centre.”

³ See Wibbels and Rodden (2006), we discuss their findings below.

federalism can help us to understand the pattern of fiscal devolution in EMU. Laboratory federalism is the time-honoured idea that “a federal system may offer some real opportunities for encouraging [...] experimentation and thereby promoting ‘technical progress’ in public policy” when a pressing social problem needs novel solutions (Oates 1999: 1132). We have added ‘fiscal’ to Oates’ (1999) expression ‘laboratory federalism’ because we explore to what extent national governments have used innovations in upward and downward devolution to get better control over their budgets, using EMU as a lever, not to what extent they have used it for policy experiments in general. Finally, we ask what the potential gain in budgetary control and consolidation in EMU means for national stabilisation.

The paper proceeds as follows: The next section summarizes the evidence on fiscal decentralisation in consolidation and stabilisation that has attracted the interest of economists in recent years. The following third section uses the conceptual framework of fiscal federalism, as outlined in the MacDougall report (CEC 1977), to highlight why the dual devolution of public finances in EMU begs an explanation, in particular for the stabilising function; we outline a tentative answer in terms of laboratory fiscal federalism which builds on Oates (1999) and is contrasted with constitutional public choice (Brennan and Buchanan 1980). In the fourth section, we provide evidence for the effects of the ‘passive’ or upward devolution of stabilisation, asking how much need for differential fiscal policy there is in EMU and how adequate fiscal policies of member states have been in this regard. We argue that there is some evidence that consolidation has been pursued to the detriment of stabilisation, and, furthermore, that central governments have endeavoured to transmit these consolidation pressures downwards through mechanisms of fiscal control that emulate the arrangements in EMU. We conclude by reflecting on the implications of this ‘isomorphism’ in fiscal surveillance.

B. The pattern of fiscal decentralisation in EU member states

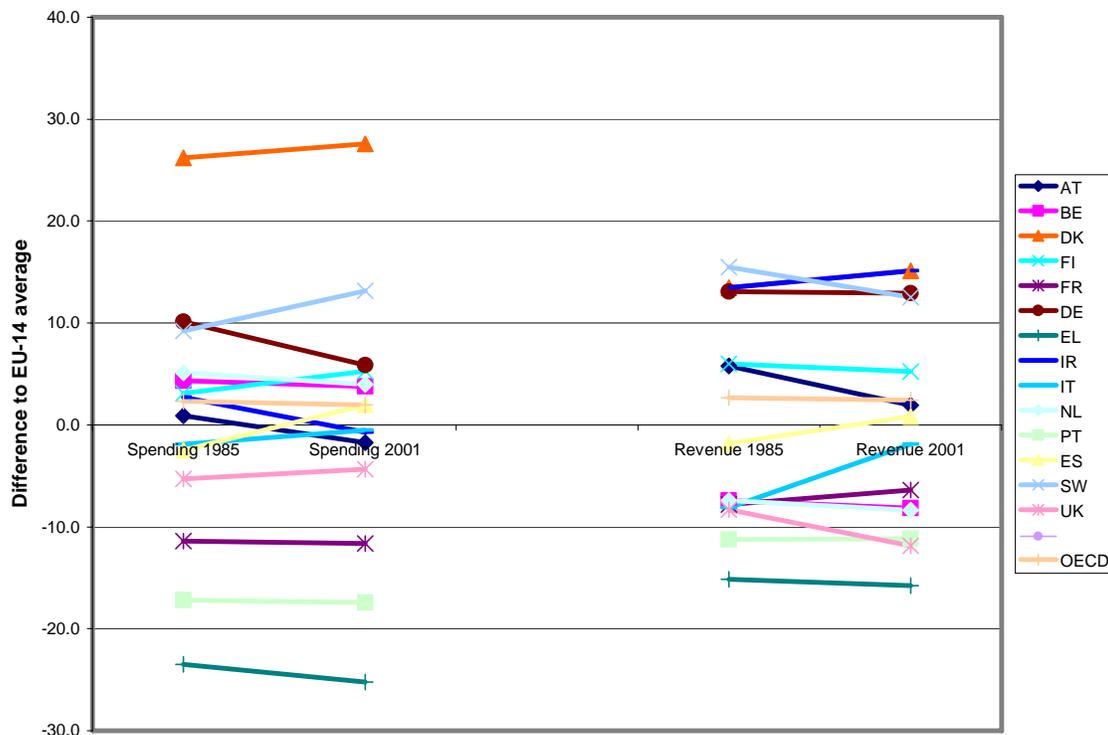
There are many reasons why countries have devolved fiscal responsibilities ever since the 1980s (Darby et al 2003, Keating 2007) which have to do with democratisation, pressures for more regional self-determination, and, sometimes, an ideological emphasis on efficiency and choice rather than equality and universalism. While consolidation was not the only and often not even the predominant motivation for decentralising fiscal relationships, we can look at how devolutions have impacted on, and were sometimes directly related to⁴, the efforts at reducing deficits and public debt that the Maastricht process called for.

Fiscal devolution in the EU-14 member states does not show much change between 1985 and 2001 if we measure it as a rising share of sub-national governments in revenue or spending of general government (graph 1). However, this measure is beset with all kinds of difficulties because it does not reveal how much autonomy sub-national governments actually have in revenue raising or spending decisions (Darby et al 2004: 5; Fiva 2006: 251-252). Typically, autonomy comes with all kinds of strings attached on the spending

⁴ Von Hagen et al (2001) explicitly analyse the attempts at consolidation in Austria, Belgium, Germany, Italy, Spain that try to get fiscal relations under control. However, the period covered is pre-EMU.

side and often not with autonomy over both the tax rate and the tax base. To that extent the measure of shares tends to overstate the degree of devolution, an issue to which we come back below. Yet, what this measure does show is that the spending side is typically more devolved than the revenue side, Ireland being the notable exception among the EU-14 countries. There is also considerable more variation between member states on the spending side than on the revenue side. But this variation itself does not change much between 1985 and 2001, there is no convergence towards an EU average. A slight divergence on the spending side is due solely to the outliers: Denmark, which is not a member of the Eurozone and interestingly enough the most devolved country in the sample although it is a unitary state, became even more decentralised between 1985 and 2001. Greece, having the most centralised fiscal constitution among the EU-14, centralised its fiscal relations even more although the change is slight.

Graph 1: Changes in fiscal decentralisation relative to EU-14 average (1985-2001)

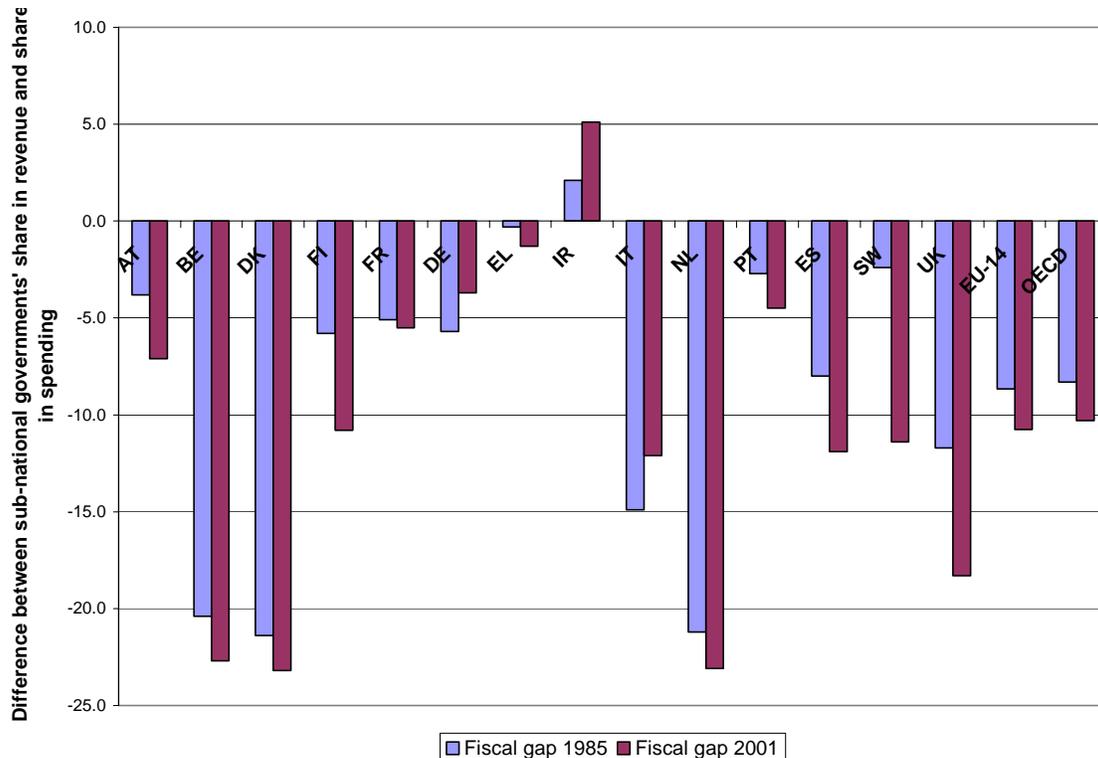


Source: own calculations based on Joumard and Kongsrud (2003: Table 1)

It is noticeable that, while eleven out of the fourteen 'old' EU members decentralised spending (only Germany centralised to some extent after unification), only five governments decentralised revenues. Three centralised with almost half of the EU-14 not changing. The result was that the EU-14 average shows a rising share of sub-national governments on the spending side but virtually no change on the revenue side. Graph 2 shows the result, a rising 'fiscal gap' (Joumard and Kongsrud 2003: 13-14) or increasing 'vertical imbalance' between own revenues and spending at the sub-central level, the difference being made up by grants or debt (Darby et al 2004: 14). Germany and Italy are

the only exceptions from this pattern of devolution. The widening fiscal gap reflects a general trend among OECD countries.

Chart 2: Fiscal gap between devolution in revenue and spending, 1985 compared to 2001



Source: own calculations based on Joumard and Kongsrud (2003: Table 1)

The signs of isomorphism in fiscal surveillance are of particular interest to us in studying fiscal relations within states in the context of EMU. What we mean by that is that the adoption of a Pact and fiscal rules at the supranational level finds counterparts in mechanisms that serve the enforcement of fiscal discipline at the sub-national level (Joumard and Kongsrud 2003: Annex; see also Bordignon 2006: 125-134). We list only those innovations that can be clearly related to EMU because of their timing:⁵

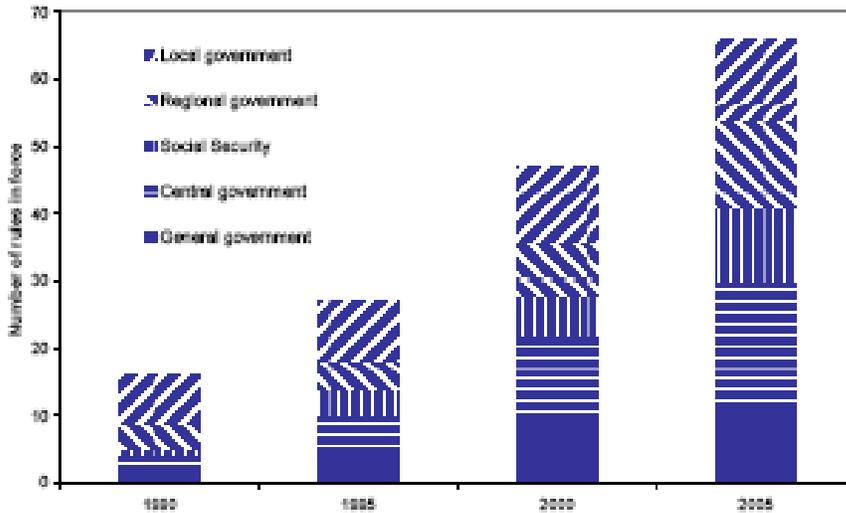
- Domestic Stability Pacts have been introduced in Austria and in Italy since 1999; while the Pact seems to work reasonably well in Austria it plays a weak if not completely irrelevant role in Italy. A National Stability Pact has also been introduced in Germany since 2003 which was directly triggered by the country's violation of the SGP; its existence did not much to prevent Germany's excessive deficits in subsequent years, however.
- Balanced Budget rules, already in place in several OECD countries, most notably the US, have been introduced for municipalities in Finland since 2001, and for regional government in Spain since 2001.

⁵ This is likely to be an underestimation of the role of EMU because countries may have changed their fiscal relations in anticipation of EMU; Italy which has undergone the most radical devolution process in the 1990s seems to be such a case (Bordignon 2006: 128).

- Debt limits have been enshrined in the constitution of Poland which was clearly drawn up with a view to accession; non-constitutional debt limits on sub-national authorities have been introduced in Portugal since 2002 and in the Slovak Republic since 2005.

The following graph 3, directly out of DG Ecfm’s annual publication on ‘Public Finances in EMU’, illustrates as well that the use of fiscal rules to rein in different tiers of fiscal systems, has considerably increased in recent years. It has to be kept in mind, however, that the rise between 2000 and 2005 is largely due to the enlargement of the union.

Graph 3: Number of numerical fiscal rules in place in EU member states



Source: Public Finances in EMU (2006: 136)

The graph shows that rules for local governments have been in place throughout the period, while rule-based surveillance of regional government, social security and central government has intensified considerably. There are qualitative differences between the rules: rules on local and regional governments tend to be legal or even constitutional, and enforcement mechanisms tend to be stronger in terms of sanctions and periodicity (generally they are specified annually). General and central government rules are often based on political agreements between ruling parties and apply multi-annually (DG Ecfm 2006: 137-138).

We now turn to the question of how to make sense of this pattern of devolution, in particular the ‘federal politics of fiscal gaps’. Increasing vertical imbalances between devolution in spending and revenue are not confined to EU countries, but they raise more questions in EMU as indicated in the introduction.

C. Using fiscal federalism theory to explain dual devolution

The fiscal framework of EMU looks rather dysfunctional from the perspective of functional fiscal federalism. This is well-known by now and will be summarized with a focus on stabilisation below.⁶ In this section we consider two alternative explanations of the framework: one based on public choice theory that sees monetary union as reining in expansionary and profligate national governments, and an account based on laboratory fiscal federalism.

The textbook theory of fiscal federalism was outlined in the MacDougall report, a study for the European Commission on the assignment and integration of public finance functions that would prepare the European Communities for monetary integration (CEC 1977). The public finance theory of fiscal federalism (Musgrave 1959, Oates 1972) tells us how the policy functions of stabilisation, redistribution and Pareto-superior allocation should be assigned optimally in a decentralised government setting. The most relevant message of this literature is in the present context that stabilisation, by way of a counter-cyclical variation of the overall government balances, should be decided and implemented at the most central level (Oates 1977: 282-287). This centralisation message is so clear that Keating (2007: 11) does not even consider stabilisation as being one of the powers to devolve. The close linkages between regional economies of a federation imply that there are significant spillovers between regional business cycles because of the fluctuations they create in interregional trade. For the same reason, openness to each other, the capacity for stabilisation at the regional level is weak since the fiscal effect, intended to stimulate or restrict regional demand, tends to 'leak' via the trade balance. Thus, only if the risks of volatility can be pooled at the central level will the constituent regions of a fiscal federation get some insurance against regional fluctuations of income and employment. Fulfilling this insurance function by the central budget requires the government to get the policy mix with monetary policy right, implying that the monetary and fiscal authorities coordinate their actions (Oates 1977: 285; 293-294). In general, the theory has assumed that a fiscal federation is a single-currency area.⁷

The MacDougall report explored how much integration of public finances is required in order to get the necessary degree of real convergence that a single currency presupposes (CEC1977: 11). Stabilisation policy at the Community level was then seen as constrained by the lack of monetary integration – ie the authors had little doubts that once governments gave up their 'jealously guarded' monetary sovereignty, a proper assignment of the stabilisation function would follow.⁸ Thus, multi-level fiscal

⁶ See the introduction to Baimbridge and Whyman (2004) or most recently Collignon (2007).

⁷ One could argue even more forcefully that one monetary policy has a differential impact on the economies of the union's members, adding a new risk to their stability; therefore fiscal stabilisation should be exercised where this particular risk originates, ie at the supranational level of monetary policy

⁸ "It is hard to envisage the adequate debt financing power and mechanisms which a Community anti-cyclical budgetary policy would require, in a framework where control of monetary policy and access to the member states' capital markets are jealously guarded national prerogatives." (CEC 1977: 57) What this also implies – and becomes explicit in some parts of the report (eg CEC 1977: 67) – is that the authors assumed

governance in the EU violates basic analytic assumptions of the theory of fiscal federalism. And quite pragmatically, it has led to the opposite of what the MacDougall report envisioned, which was a degree of budgetary centralisation to prepare for monetary unification. The Maastricht Treaty led to devolution upward (decentralisation by creating a supranational tier for monetary policy and fiscal surveillance) and the regulatory fiscal policy of the supranational level now urges national stabilisation to serve above all the provision of the public good ‘sound money, sound finance’ for the monetary union as a whole. One obvious explanation for this ‘perverse’ architecture is that these distortions are created by an incomplete political union and the lack of a fiscal constitution that goes with it (eg Collignon 2007). However, this is hardly an explanation but a way of highlighting the puzzle: how could the proponents of EMU claim that the monetary union will lead to improved stabilisation and more stability if this union defies standard economic principles?

One way of making sense of the fact that European integration seems to contradict fiscal-federal principles is normative or ‘constitutional’ public choice theory (Brennan and Buchanan 1980: ch.9). Here federalism is analysed as a constitutional way of preventing a monolithic government that exploits its citizens, by creating competition between jurisdictions, mainly through trade and unrestricted migration. What fiscal federalism perceives as a problem, regulatory and fiscal competition, is seen as a solution in public choice, once the ‘benevolent despotism’ view of government of welfare economics is replaced by the Leviathan view of government. Applying this view to EMU, we can see that the devolution which monetary integration has inevitably meant for macroeconomic stabilisation in member states is normatively desirable: it holds interventionism and fiscal activism in check since more of it would benefit neighbours rather than domestic constituencies. Similarly, more price and wage transparency and the increased mobility of capital create more competition and thus discipline high tax countries.

To explain why Leviathan, being what it is, would thus constrain itself, the normative or ‘constitutional’ branch of public choice theory must explain the entry into EMU by a combination of the Olsonian logic of collective action and Putnam’s two level-game (Rotte 2004: 51-53; cf Vaubel 1994): Governments entered an international commitment to rein in unsustainable fiscal profligacy at home. Either there was a successful revolt of the median voter against ongoing fiscal profligacy driven by special interests or Leviathan realised that fiscal exploitation is punished by way of a dwindling tax basis and high interest rates on public debt.

If this public choice interpretation of devolution in EMU is correct, we should see two things. At the national level, we should see less activist fiscal policy, and at the subnational level we should see a shift towards ‘competitive federalism’ (Keating 2007: 18), which, by creating tax competition, would force lower tiers of government to reduce

that monetary integration would follow closer political and real integration, not serve as a vehicle to achieve the latter.

spending and taxation.⁹ We present some evidence of activism on stabilisation in the next section. For now we can note that the pattern of devolution to subnational governments is not consistent with a competitive federalist interpretation. On the contrary, expenditure has been devolved more than revenue. This uneven devolution reduces rather than intensifies tax competition, while on the expenditure side, local interests may get even more reason to lobby sub-national authorities for spending programmes that benefit them. This is the main reason why vertical imbalance may lead to soft budget constraints: if sub-national governments get spending powers without the corresponding revenue raising powers, they tend to see budget constraints as a matter of negotiation, resulting in excessive transfers, or of co-insurance that they can manipulate by provoking a bail-out ex post (Bordignon 2006: 121; 124-125). This seems to have been the case in Germany and Italy but not in Sweden. A countervailing force to the incentives for overspending is that the central government may reveal it as such, for instance by benchmarking regional expenditure on local services (e.g. standard spending assessments in the UK), so that regional and local authorities get the political blame for mismanagement. But this seems not always to work: In his econometric study of 18 OECD countries that takes account of information on the statutory constraints on local autonomy, Fiva (2006) finds that devolution on the spending side decreases the size of the budget, in line with the tax competition framework backing the Leviathan hypothesis, while devolution on the spending side increases the size of budgets. Vertical imbalance should then favour an asymmetric expansion of spending, with knock-on effects on local indebtedness or inter-governmental transfers.¹⁰

Furthermore, the extension of fiscal control by central government and innovations in national pacts, debt limits and balanced budget rules constraining subnational governments, are also not favourable to the constitutional public choice explanation. If anything, Leviathan in the disguise of central government has become more pivotal in the entire fiscal architecture. Central government has all the responsibility for compliance with EMU and consequently attempts to exercise this responsibility vis-à-vis lower tiers of government. The normative branch of public choice would rather call for responsibility to be devolved, and only serves to highlight the puzzle: why was there this trend towards rising vertical imbalance if that creates problems for consolidation and puts more pressures on central governments which are struggling to come to terms with the constraints imposed by EMU?

Thus we turn to an interpretation that is broadly compatible with a functionalist federalism view in a situation where a particular set-up is out of institutional equilibrium: this amounts to looking at federalism from the perspective of the political economy of

⁹ Note that the principal-agent theory or financial contracting approach to fiscal federalism would lead to the exactly opposite prediction: here, devolution is seen as raising a number of incentive problems that may lead to soft budget constraints for sub-national governments (see Bordignon 2006 for a careful discussion).

¹⁰ It is difficult to establish that this is because of a moral hazard problem created by rising fiscal gaps, for one because its manifestations can be completely different (too little or too much sub-national debt, depending on whether excessive transfers ex ante or an unwarranted bail-out materialised) and because sub-national debt may have occurred because central funding was inadequate, not because the sub-national government engaged in free-riding and changed its spending behaviour.

reform. Laboratory federalism turns basic tenets of functional public finance on its head by explaining that devolution provides opportunities for learning in a situation of imperfect information (Oates 1999: 1131-1134). The information problem that monetary union has created is how governments can fulfil their basic functions in a framework of fiscal surveillance that prioritizes fiscal consolidation. Devolution provides the space for finding novel solutions by decentralising the responsibility for budgetary policy, thus containing the risk to the rest of the polity in case an experiment fails. It is the role of the central level to provide the public good of lesson drawing in sufficient quantity. The approach retains a functionalist, problem-solving underpinning characteristic of the mainstream of fiscal federalism, while the specification of the setting – imperfect information with learning externalities – allows it to explain more decentralisation than is warranted by the standard theory.

Leading examples of laboratory federalism include reforms to social assistance and employment programmes that aim to increase the flexibility of local and regional governments in adapting programmes to local conditions and addressing local problems. A feature of these examples is that the fiscal function of redistribution, which is usually assigned to the national level, is devolved. Fiscal competition is, however, avoided by the maintenance of national legal frameworks for provision and by shared financing arrangements between central and subnational levels (Mabbett and Bolderson 1998). These examples reveal an important problem with the standard fiscal federalist model which, interestingly, was commented on by Oates (1977) in his contribution to the MacDougall report. The functionalist theory of fiscal federalism assumes that the government powers of stabilisation, redistribution and allocation (public goods provision) can be clearly differentiated (Oates 1977: 301). An analytical way of separating them is: stabilisation tries to dampen the volatility around the trend growth of income; redistribution tries to make the trend income (of different regions or individuals) converge; allocation tries to make this trend to converge upwards by realizing Pareto gains, turning the distributive zero-sum game into a positive-sum game. In practice, however, welfare state reform programmes frequently bring together redistributive and allocative functions, for example in trying to improve the functioning of the labour market or in other ways enhance the operation of ‘social policy as a productive factor’. Furthermore, redistributive social programmes provide an automatic mechanism of countercyclical expenditure adjustment, so they overlap with the stabilisation function as well (Mabbett and Schelkle 2007). This creates the danger, much commented on in the context of US welfare reform, that if governments devolve spending which is predominantly on social services without paying attention to countercyclical financing,¹¹ they may force subnational governments to engage in pro-cyclical expenditure that affects the stabilising capacity of the tax-transfer system as a whole (Wibbels and Rodden 2006).

The implication of this is that a fiscal federalist assignment of policy functions could not be preserved in a world of social policy experiments which blur the distinctions between

¹¹ For example, if they underfund the mandate to provide services, in an effort to enforce cutbacks in provision (Joumard and Kongsrud 2003: 22-23).

functions and aim to find policies which fulfill multiple functions in complementary ways. Furthermore, if we look at the way that fiscal surveillance has evolved in EMU, we find the same blurring in the course of identifying priorities for fiscal consolidation. In EMU, the overarching norm of fiscal sustainability imposes a criterion of intertemporal efficiency, ie allocation, on the stabilisation function and, in the revised Pact¹² on redistribution. Measures promoted under consolidation pressures such as the closing down of early retirement schemes and the promotion of tax credits for working parents in place of unemployment benefits or social assistance, turn redistributive policies into allocative ones.¹³

Along with this mixing of policy areas and functions, we also find that the assignment of executive competences is not clearly defined as it should be in a fiscal federalist framework. In EMU, this is true both of supranational-national and of national-subnational relationships. The governance levels of fiscal stabilisation are intertwined: we have the EU, in the disguise of DG Ecfm and the Ecofin Council of Ministers, exercising fiscal surveillance at the supranational level but not providing any fiscal means for achieving compliance. The responsibility for complying with the fiscal rules in E(M)U lies solely with national authorities who in turn depend on the cooperation by sub-national fiscal authorities and, in some member states, by the semi-autonomous public agencies (parafisci) providing social security.¹⁴

This intertwining is a problem for laboratory federalism in that it looks more like a way of sharing the risk of political blame than a way of containing risks from an experiment for the rest of the federation (Oates 1999: 1131). But it can be reconciled with laboratory reform politics in that the intertwining of government levels is a way of enforcing the 'revolution from above', ie national governments wanting to make sub-national governments change their ways, with the stipulations of the Pact and the BEPG as a pretext for changes. This alternative would suggest that we should see changes that actually give sub-national governments some leeway for experimentation while the central government level tries to keep control, say through regulatory oversight such as standard-setting, that reins in the incentives for sub-national overspending.

¹² Governments must now include long-term projections of their public finances in their stability and convergence programmes to get a grip on the liabilities of old-age security; the on-set of the Excessive Deficit Procedure can now also be stopped for up to five years if governments can demonstrate that a deficit above (but close to) 3% of GDP is due to the introduction of a mandatory, fully funded pension pillar which promises fiscal savings in the long run.

¹³ In another paper, we analyse how the EU reconstructs distributive policies as allocative policies (Mabbett and Schelkle 2006).

¹⁴ In some member states, these parafisci or semi-autonomous public agencies that administer pensions, health care and unemployment insurance, control a higher share of the general government's fiscal resources than the central government. In Germany, for instance, their share in general government spending amounts to more than 40% while that of the sub-national governments (Bundesländer) is a bit less than 40% and the central government (Bund) the remaining 20% (all figures for 2005, see presentation of Snelting and Brunton at the LSE workshop, available on the Newgov website).

A further implication of the idea of laboratory fiscal federalism is that it does not describe equilibrium or stability in functions and assignments, given that its purpose is to promote innovation and reform. The political economy of reform (Rodrik 1996) and experiences with policy learning and transfer (James and Lodge 2003) suggest that learning and subsequent reforms are not straightforward processes. On the contrary, both literatures provide plenty of reasons why we should expect an inherent preference for business as usual, a status quo bias, making any intended change the exception that proves the rule. To overcome the status quo bias, governments must break the routines and rules that favour existing interests, which typically means to change procedures, ways of doing things rather than directly the things to do, ie the policies themselves. Laboratory fiscal federalism, devolution or reassignment of fiscal responsibilities to allow for innovation, is such a reform strategy.

How would this political economy approach to laboratory federalism explain the case of macroeconomic stabilisation in EMU? It has been amply documented, most notably by McNamara (1998) and Dyson and Featherstone (1999), that the ‘road to Maastricht’ meant a break with a particular understanding of Keynesianism which had neglected the inflationary consequences of fiscal activism. Reining in ever higher fiscal deficits became a priority, when counter-cyclical stabilisation seemed to work only too well, namely driving budget deficits in a protracted phase of stagflation. The entry criteria of the Maastricht Treaty as well the ensuing institutions to supervise the adjustment process, such as the Broad Economic Policy Guidelines (BEPG), can be seen as manifestations of laboratory federalism, asking all pupils in class to report progress on agreed indicators which is then benchmarked and peer reviewed.¹⁵ The fact that even countries that are not members of the monetary union have subjected themselves to the BEPG process can be interpreted, optimistically, as seizing the opportunity for learning. Moreover, it can be seen as evidence of lesson drawing that the Austrian, Italian and the German government have introduced SGP-type control mechanisms and other member states have implemented numerical fiscal rules, often focusing on deficit and debt limits analogous to the SGP.

This interpretation may also make us understand why the original Pact could not be upheld: its intended quasi-automatism and hard sanctions under the Excessive Deficit Procedure did not acknowledge imperfect information or the uncertainty there is (Schelkle 2005). National budgetary processes are still adjusting to the emphasis on consolidation and long-term sustainability while counter-cyclical stabilisation has been constrained to an unknown degree. Political institutions in member states have not necessarily found their role yet, especially in relation to detailed fiscal surveillance exercised by the Commission and Eurostat, which may raise problematic issues for the scrutiny by national parliaments and for the division of responsibilities between levels of government. Under these circumstances, the attempt to enforce strict common rules may militate against learning and favour a return to the bad old ways. The revision of the Pact

¹⁵ This makes EMU even a more pertinent example for laboratory federalism than the US welfare reform that Oates (1999) had in mind, which has no forum for the exchange of lessons or an agreed system of indicators to measure success in different states (Walker and Wiseman 2006).

has arguably taken this into account and is more conducive to laboratory fiscal federalism (cf Schelkle 2007).

Laboratory federalism can make broad sense of the politics of vertical imbalance although we do not claim this to be the only possible explanation. In the EMU context, this recasting of fiscal responsibilities between national and sub-national governments is in line with the requirement of keeping overall control of the budget without losing sight of the fact that even in times of ‘permanent fiscal austerity’ (Pierson), crucial government functions must be fulfilled. Greater leeway or autonomy on the spending side could be rationalised as providing the means for experimentation with spending programmes by lower tiers of government, in line with considerations for greater efficiency and accountability. However, this gain in room for learning and experimentation would undermine the goal of consolidation if soft budget constraints become more of a problem. Thus the implementation of additional control mechanisms that reduce the degree of effective devolution; it is noticeable that the strings attached on sub-national authorities resemble the constraints that have been imposed on national governments by the EU level. This can be seen as lesson drawing of sorts.

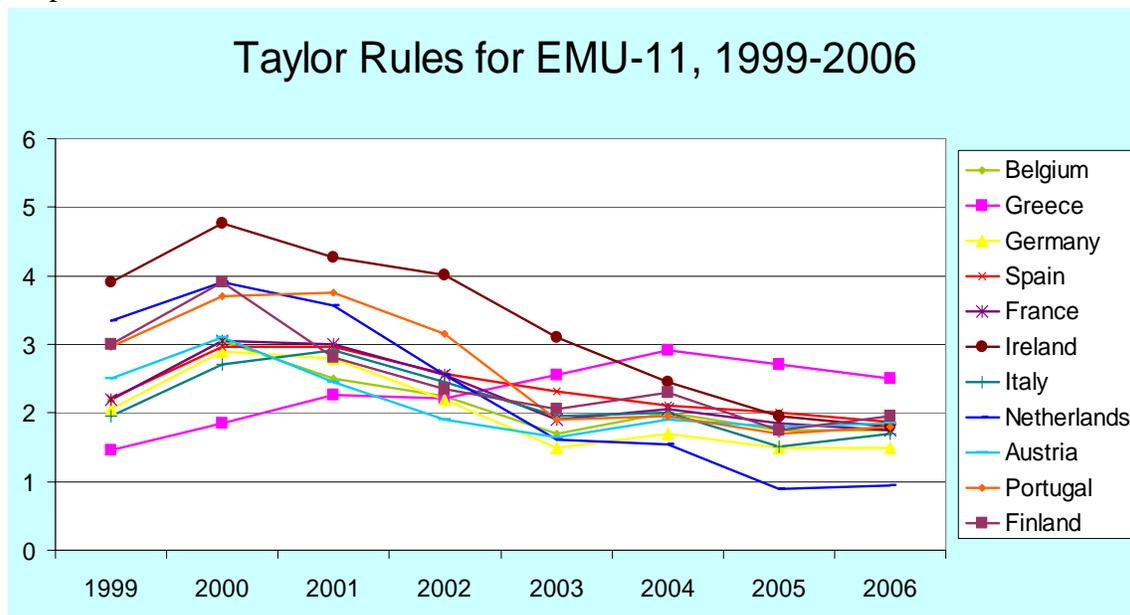
D. Stabilisation in laboratory fiscal federalism

In this section, we examine the issues that laboratory fiscal federalism raises for stabilisation, both for EMU as a whole and for the sub-national level of particular member states. We argued that upward and downward devolution can be seen as an isomorphism in fiscal surveillance where the upper tier (the EU or national government) exercises SGP-type control with the aim of consolidation on the lower tier (national or sub-national authorities, respectively). In the case of upward devolution, this raises the problem of whether national governments are able to combine the stabilisation of the domestic economy with the need for stabilisation of EMU as a whole. In the case of downward devolution at least two questions arise, namely first how well the stabilisation of regions within the domestic economy fits into the EMU framework and second whether the isomorphic control mechanisms that have been introduced in the form of national stability pacts show some consideration of regional stabilisation; we can only report some evidence on the first part and have a closer look at the three national stability pacts with respect to the second.

On the first issue of upward devolution, we try to assess how effective fiscal stabilisation in EMU has been, against the odds that there is no coordination of the aggregate fiscal stance complementary to monetary policy. Following and updating empirical work done by Gramlich and Wood (2000), we assess, first, how much need there is for a differentiated response to macroeconomic developments in EMU member states. Second, we ask how well member states’ fiscal systems did and do respond in terms of automatic and discretionary stabilisation but also consolidation, looking at actual and structural budget balances and how they correlate with their own output gaps. Third, we evaluate whether this differential response adds up in the aggregate to a fiscal stance that is consistent with the required policy mix.

How different should macroeconomic stabilisation have been for EMU members? Following the methodology of Gramlich and Wood (2000), we assess this by calculating Taylor rules for different member states. A Taylor rule calculates the central bank interest rate that would have been in line with a country's cyclical situation (output gap measured as actual minus trend GDP in percent of GDP at 1995 market prices) and inflationary pressures (price level increases above the central-bank's target which we assume to be 1.5%), assuming a stable 'neutral' or long run equilibrium interest rate and a certain weighting of the goal's of employment and price stability in the central bank's objective function. We assume a neutral interest rate of 2% which was the long-term real bond rate in 2004 when EMU as a whole had no output gap. We also assume as symmetric weighting of the two stability goals (weight of 0.5). Graph 4 shows the results of this stylised evaluation which is only meant to be indicative.¹⁶

Graph 4: The need for differential interest rates in EMU



Source: AMECO database, figures for 2005-2006 are estimates subject to revision

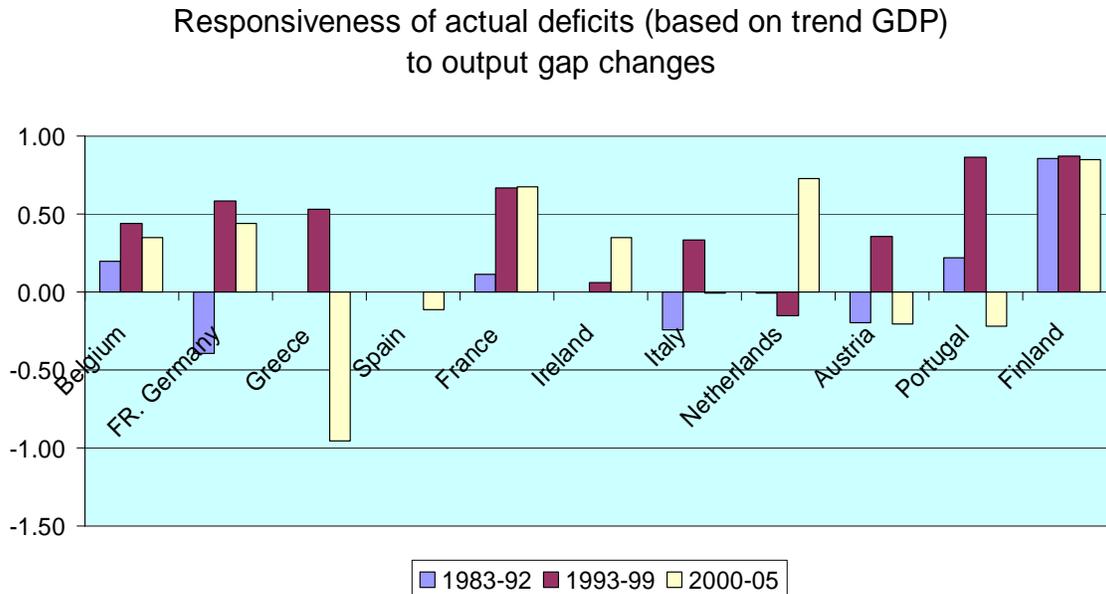
In 1999-2000, the difference was 2.5-3% which converges to 1.5% in 2004 when the output gap for Euro area was close to 0. This suggests that even in real equilibrium for EMU as a whole, we need different fiscal responses. However, if we disregard Greece and later Netherlands, the range becomes fairly narrow, about 0.5%.

How well did fiscal policy respond to the need for differential national responses? Again following and updating Gramlich and Wood (2000), we look at whether general budget balances have a counter-cyclical or a pro-cyclical stance which we measure by positive or

¹⁶ Thus, the formula for each country is: $i^* = r^* + 0.5(\text{output gap} + \text{excess inflation})$ where the the output gap and excess inflation is country-specific, r^* is the neutral real interest rate.

negative correlations between changes in budget deficits and changes in output gaps.¹⁷ The correlation with the actual balance is indicative of the operation of automatic stabilisers (e.g. income taxes or unemployment benefits that vary with the cycle, without government discretion) while the correlation with the structural or cyclically adjusted balance (excluding interest payments on public debt) indicates how actively the government may have pursued a counter- or pro-cyclical fiscal policy.

Graph 5: Counter- or pro-cyclical stance of actual balances

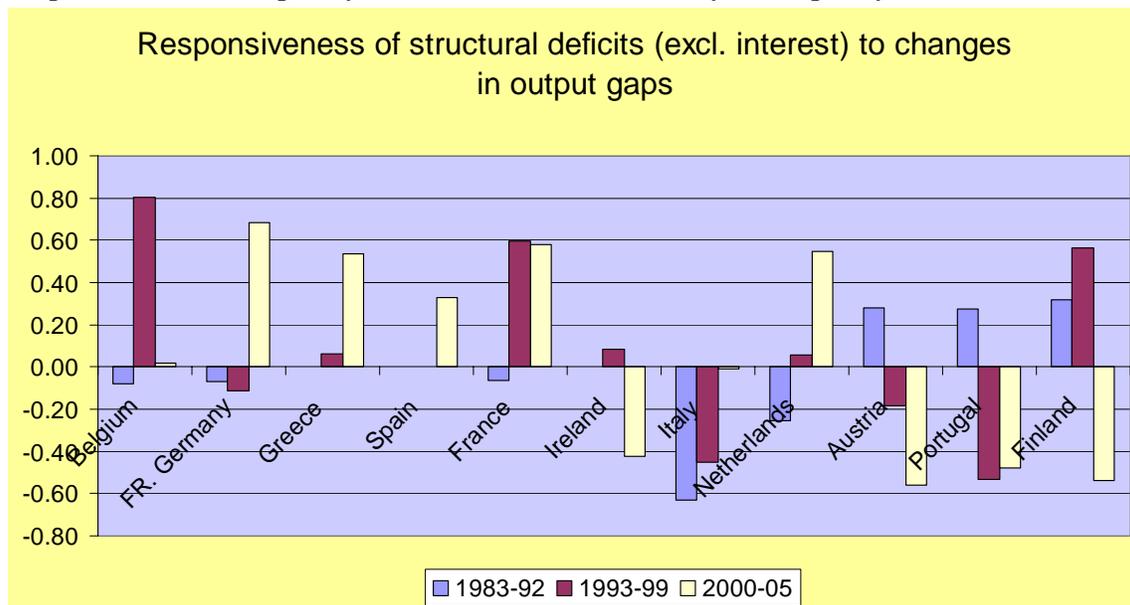


Source: AMECO database

The majority of countries had a counter-cyclical stance in the actual balance, which suggests that their automatic stabilisers work well. But there are also a few pro-cyclical ‘sinners’, among them Greece and Portugal, and surprisingly Austria which did not violate the Pact rules. Interestingly, other countries that are or were in breach of the Pact have improved their counter-cyclical stance in EMU (France, Germany, Italy and the Netherlands).

¹⁷ A positive correlation indicates a desirable counter-cyclical stance because the budget deficit goes up if the output gap, the shortfall of actual relative to trend output, goes up (both are negative figures but the correlation looks at them in absolute terms).

Graph 6: Counter- or pro-cyclical stance of discretionary fiscal policy

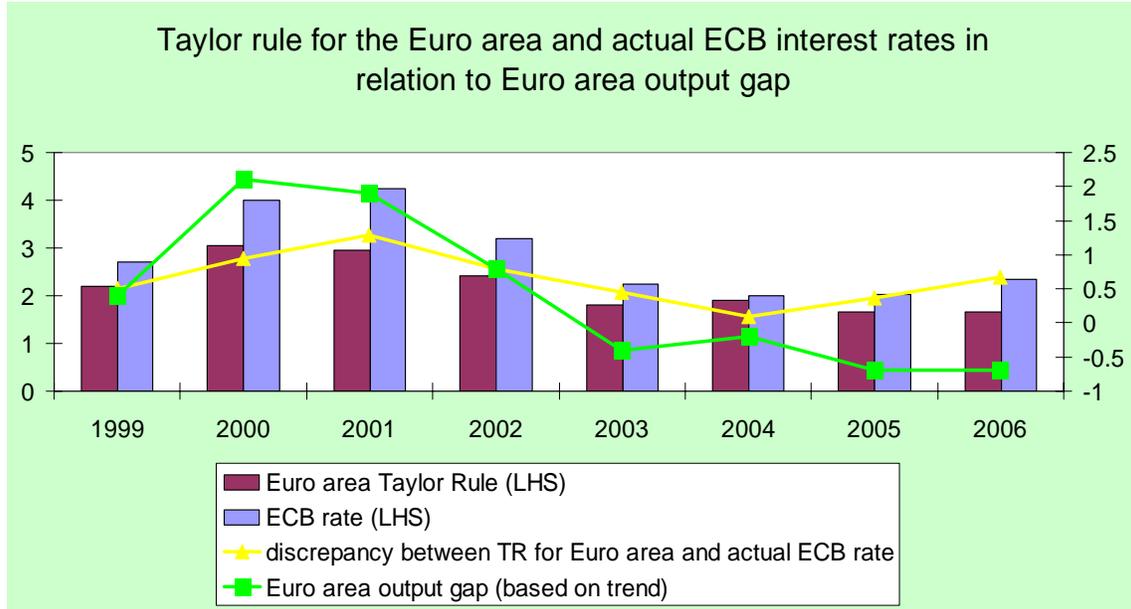


Source: AMECO database

Among the delinquent countries, only Portugal can be accused of a pro-cyclical discretionary stance; Italy is neutral while all others try to exercise a counter-cyclical stance. While this cannot be more than indicative of what governments' fiscal behaviour, it does suggest to us that breaking the stipulations of the original SGP is a genuine problem of fiscal control in a multi-level setting and member states have not done as badly in coping with it as the mainstream view has it.

Finally on the issue raised by upward devolution, how effectively has national stabilisation contributed to stabilisation of EMU as a whole? We first look at the Taylor rule, calculated as before but for EMU-11 as a whole, compared to the actual ECB rate and then to what extent different budget deficit measures have corresponded to the monetary stance.

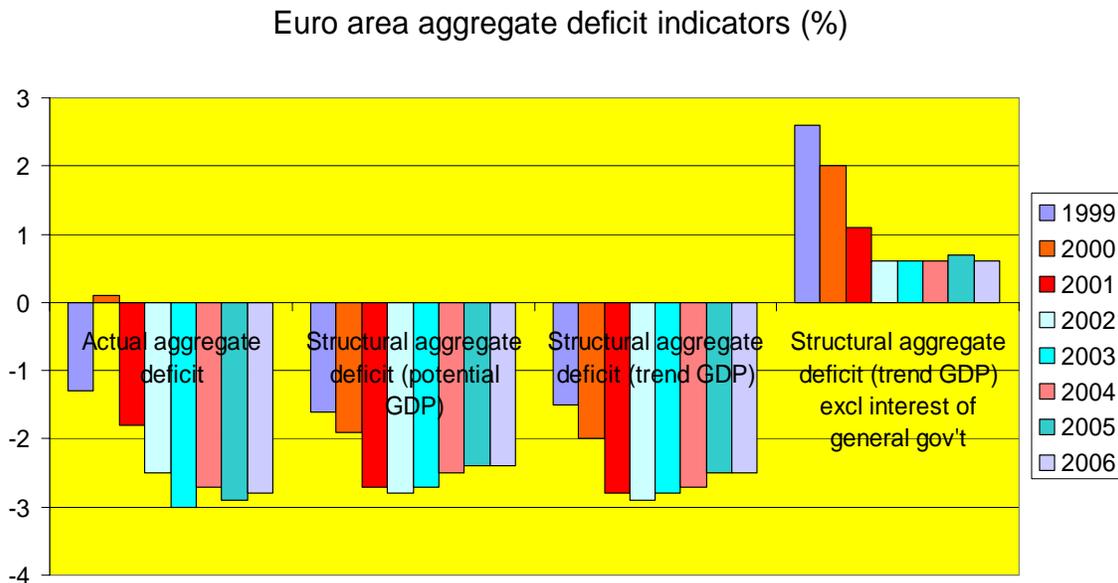
Graph 7: The monetary stance in EMU



Source: AMECO database

The stance of ECB monetary policy was continuously a bit more restrictive than a Taylor rule would have suggested but given our inevitably arbitrary assumptions about the weighting of ECB goals and the neutral interest rate we do not consider this to be a very significant result. What is significant is that the ECB interest rate did first move counter-cyclically with a positive output gap, but then was slow to respond to worsening of the cyclical situation since 2001, although the move is not completely out of tune with the movement in the output gap.

Graph 8: EMU fiscal stance (1999-2006)



Source: AMECO database

The indicators of the aggregate fiscal deficit show a lack of fiscal discipline or compliance depending on which measure we look at. When the output gap was positive, the Euro area overall above trend growth, the actual aggregate deficit was well within the 3% criterion; if we look at the two cyclically-adjusted measures including interest rates it looks as if countries were collectively delinquent and stimulated pro-cyclically, in later years counter-cyclically. But if we exclude interest payments, the aggregate fiscal stance was remarkably tuned towards the EMU output gap situation and recently even supporting the ECB's relatively restrictive monetary stance. This means that aggregate discretionary fiscal policy has become slightly pro-cyclical in recent years, thus sacrificing stabilisation to some extent to consolidation. In other words, the fiscal indicators suggests that it is history (stock of public debt) rather than present day delinquency that makes member states' budgetary policies look as if they were overall non-compliant; and if governments try harder to comply, they easily risk making it more difficult for the EU area to get out of the current phase of stagnant growth.¹⁸

Turning finally to the issues raised by laboratory fiscal federalism in downward devolution, we ask how well regional stabilisation fits into devolved national stabilisation outlined above and to what extent the national stability pacts show some consideration for the stabilisation of the sub-national economies thus controlled. For a preliminary answer on the first question, we can draw on Wibbels and Rodden (2006) who looked how well federations, all over the world and outside EMU, generate regional stability and stabilisation policies.¹⁹ They first establish that own-sources of revenues of sub-central governments tend to be highly pro-cyclical, for instance sales taxes increase in booms and go down markedly in recessions. This would not be a problem or actually is as it should be for a counter-cyclical stance of devolved budgets as long as this does not force regional or local authorities into pro-cyclical variation of expenditure in order to keep a balanced budget. Thus, the next question they ask is whether regional authorities have access to borrowing so as to make up for the shortfall in revenue during recessions, or, if they are subject to a balanced budget rule, whether grants from the central level are counter-cyclical to make up for the shortfall. Wibbels and Rodden (2006) find that borrowing is a way of smoothing expenditure in Spain (and Australia) only while discretionary grants from central government has a pro-cyclical tendency, contrary to what they should from a functional point of view. Moreover, even in Spain (and Germany, the US and others) the pro-cyclicity of revenues does translate into pro-cyclical expenditures (Wibbels and Rodden 2006: 174). This behaviour of expenditure is, as they note with respect to results by Hallerberg and Strauch for instance, in marked contrast to national expenditure which shows counter-cyclical and thus stabilising behaviour.

The issue this raises for EMU is this. We have seen that devolution to subnational governments might be part of a consolidation strategy: one that endeavours to minimise

¹⁸ A noteworthy feature of all fiscal indicators in graph 8 is their inertia since 2001 even though the business cycle has moved quite a bit.

¹⁹ For lack of detailed regional data, Wibbels and Rodden (2006) look at eight federations of which only two, Germany and Spain, are in the EU.

the welfare costs of fiscal consolidation by promoting social policy experiments. However, subnational governments are weak stabilisers, so shifting the burden of compliance with consolidation could come at the cost of stabilisation. The innovations in federal fiscal surveillance, the national stability pacts, can give us some hints about the burden shifting or sharing, in particular whether they indicate any considerations for the need to control budgets but also maintain a capacity for stabilisation. A brief analysis of the three national stability pacts show some creativity in avoiding at least a worsening pro-cyclical stance of regional fiscal policies (Joumard and Kongsrud 2003: Annex; cf DG Ecfm 2006; Annex 1):

- The Austrian stability pact requires municipalities as a group to balance their budget over a multi-annual period while regions as a group have to produce annual surpluses of at least 0.75 percent of GDP. The pact provides the possibility to transfer deficits or surplus ratios to other regional governments. Thus, the group responsibility allows to pool and compensate risks at least within a group. The auction or transfer principle, analogous to the proposal of tradable permits of Casella (1999), allows response to region-specific shocks through horizontal redistribution, without offsetting the national level. The Pact establishes thus a division of responsibilities between tiers of government for both stabilisation and consolidation.
- The German pact imposes spending caps on the regional governments ('Länder') which allows them to respond to cyclical fluctuations with the variation of taxes or borrowing. Given that tax revenues are mostly shared, they have access to borrowing which is constrained by Golden Rules that constrain borrowing to financing investment. These Golden Rules correspond to a Golden Rule at the national level. A cooperative committee has the oversight, which peer reviews performance and can make recommendations in the case of non-compliance. In other words, the Pact tries to extend the same obligations that the national government has under EMU and the German constitution on the sub-national levels.
- The Italian pact requires deficit reductions from regional governments relative to a no-policy-change baseline. It does so on a cash basis (which invites creative accounting, namely ordering services etc in the current fiscal period and defer payment to the next) and exempts some acyclical spending, such as on health care (so that a major item of discretionary spending is not affected by the obligation to consolidate which forces regional authorities to comply by cutting down on cyclical spending items). Thus, the national pact shifts the burden, its stipulations show little sensitivity for cyclical stabilisation needs of regions and thus achieves consolidation at the cost of stabilisation.

Our interpretation of this qualitative piece of evidence, provided by laboratory fiscal federalism in EMU, is that most member state governments are actually aware of the inherent tension there is between consolidation and stabilisation. Devolution and sharing of the obligations under EMU makes these tensions even more precarious and there is still experimenting going on.

E. Conclusion: Coping with imperfect information and institutional constraints

In this paper, we explore what the dual process of fiscal devolution meant for the stabilising capacity of member states in EMU. The upward devolution, resulting from the decision of EMU architects not to create a central budget that corresponds to supranational monetary policy, prioritizes national fiscal consolidation over stabilisation of the union. This is seen by many as the price to be paid for a lack of political integration (De Grauwe 2006, Collignon 2007). There was also a process of downward devolution at the level of the politically integrated member states, not necessarily triggered by EMU, but starting in the 1980s when the good times of fiscal expansion had definitely come to an end and were replaced by the bleak vision of ‘permanent fiscal austerity’ (Pierson). We argued that the two most noticeable trends of this downward devolution were, first, an increasing fiscal gap between (less) decentralized revenue and (more) decentralized spending and, second, an emerging isomorphism between the regulation of national budgets by the EU and the regulation of sub-national budgets by national government, domestic stability pacts providing the clearest example of this isomorphism in multi-level fiscal surveillance.

One way of making sense of dual devolution is constitutional public choice, since it turns the mainstream theory of fiscal federalism on its head: fiscal competition is good because it keeps exploitation by Leviathan in check. Yet, both the rise in the fiscal gap and tighter regulation of sub-national budgets, e.g. by setting quality standards for local social services, mean that there is limited fiscal competition. Therefore, we took recourse to the notion of laboratory fiscal federalism. The first step in our argument is to note that EMU creates a rather difficult situation for national governments (cf Wibbels and Rodden 2006: 161): first, they are responsible for compliance with the fiscal rules in EMU while they depend on lower tiers of government for achieving that, and second there is a tension with stabilisation even if they succeed in compliance.

Upward devolution of the stabilisation function thus seems to have created a situation with which national governments must cope and one way of doing so is downward devolution. Laboratory fiscal federalism means exactly that central government creates the space and incentives for experimentation, here of how every tier can contribute to the fiscal consolidation effort without jeopardizing stabilisation. The evidence on aggregate fiscal stabilisation in EMU suggests that national governments have actually not done as badly as the demise of the original Pact suggests. Governments have tried to comply as far as their discretionary fiscal policy is concerned; trying harder, as in recent years could actually be (mildly) destabilising for EMU as a whole. National governments have also tried to devise fiscal rules, in particular domestic stability pacts, that indicate the effort to strike a balance between consolidation and stabilisation. Thus, we conclude that this challenge is built into the fiscal federal framework of EMU but experience so far suggests that national governments cope more constructively with it than they are usually given credit for.

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