

Fiscal federation or confederation in the European Union: The challenge of the common pool problem

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Abstract

The theory of fiscal federalism prescribes conditions for decentralization of government responsibilities, but with a bias towards a strong central government. In the EU context, the standard theory suggests the establishment of fiscal institutions to handle public goods and with taxing authority in Bruxelles. This article evaluates the experiences made with multi-level public finance within countries in Europe. In practice decentralization of government easily involves common pool problems related to vertical and intertemporal fiscal imbalances. Central governments find it hard to commit to hard budget constraints, and overspending and deficit bias results. Political strength of the center seems to be a precondition for a successful federalism, political centralization must balance economic centralization in fiscal federations. For the EU, this implies a choice between the continuation of a weak center and limited fiscal authority to avoid the common pool problem (fiscal confederation) or broad fiscal responsibilities with strong political centralization to police the common pool problem (fiscal federation).

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1. Introduction

In the recent debate about policymaking and fiscal arrangements in the European Union, many contributors refer to the guidelines of fiscal federalism. The standard theory of fiscal federalism (the Musgrave-Oates-Tiebout model) prescribes major fiscal operations at the central government level. Given a benevolent planner at the center, the theory develops arguments for decentralization. Since the gain of decentralization relates to the heterogeneity of preferences for local public goods, the main tasks of government are assumed centralized. Based on this thinking it can be argued that the EU needs major fiscal institutions to handle public goods, redistribution and stabilization,

The competing view of fiscal federalism is more decentralist in nature. The advantages of fiscal competition represent a case for decentralized government. Brennan and Buchanan (1980) designed the alternative competitive federalism where decentralization is a mechanism to control inefficient central government. In this setting, the role of central government is less clear, but it is strong enough to be a worry. The comprehensive literature about 'Leviathan' government is not explicit about the sources of government failure at the center. The present EU system where country governments dominate is in the spirit of this fiscal competition.

The European Union today is a confederation with limited fiscal responsibilities. The public finances are primarily a responsibility of the national level, and the EU level basically covers regional funds, agricultural subsidies and administrative costs financed by member state contributions. Establishment of EU level fiscal institutions and policy

implies new multi-level public finance arrangements. While the standard theory analyzes the advantages and disadvantages of decentralization, the challenge for the EU design is the other way around, the establishment of bottom-up centralization. Nations must come together to set up a fiscal structure above.

Most contributors to the debate about EU fiscal institutions are not satisfied with the present design. Oates (2001) concludes that 'the emerging European public sector may find its structure rather ill-suited', emphasizing the redistribution and stabilization functions. The centralist model emphasizing the need for EU level public goods and tax financing is most vigorously presented by Tabellini (2003). The broader political aspects of the centralist model are laid out in Berglof et al. (2003). On the other side, Alesina and Wacziarg (1999) argue that the EU already has 'gone too far' in centralization given the existing preference heterogeneity. Broader discussions of decentralization and design include Persson et al. (1997) and Mueller (1997).

In this article we will bring in the experiences from fiscal federalism in practice. The empirical literature addresses an aspect that basically is assumed away in fiscal federalism theory, the issue of fiscal discipline. Recent collections of country studies by Rodden et al. (2003) and Dafflon (2002) discuss the concern for opportunistic behavior, excessive government and fiscal imbalance in federalist systems. They form the background of the 'dangers of decentralization' discussed by Prud'homme (1995). The lessons made of decentralization within countries are helpful for the design of new structures in the EU.

Section 2 presents the challenge of fiscal discipline embodied in multi level public finance, the common pool problem and the mechanisms of overspending associated with vertical fiscal imbalance. Section 3 discusses the empirical foundation of the overspending hypothesis based on experiences with local governments. Section 4 extends the discussion to intertemporal aspects of fiscal discipline and their associated fiscal controls. Consequences for EU fiscal design are addressed in section 5. Concluding remarks are offered in section 6.

2. Fiscal federalism and fiscal discipline

The conventional theory of fiscal federalism is really a theory about decentralized government. Given a benevolent social welfare maximizer at the center, the arguments for decentralization are evaluated. Decentralization of public goods accommodates preference heterogeneity, but must be traded off against the disadvantages associated with economies of scale and externalities. The theory designs well-functioning decentralized governments that can handle the responsibilities with accountability. The workhorse Musgrave-Oates-Tiebout model (Musgrave, 1959, Oates, 1972, Tiebout, 1956) is based on four key assumptions: Local public goods, benefit taxation, mobility, and no spillovers. The strength of the local public sector in this setting is competition (Tiebout) and balancing of local benefits and costs (Oates' decentralization theorem). Local governments in this design are like Buchanan (1965) clubs established by the local

population to solve common problems. Benefit taxation assures local accountability, and there is no case for central government financial controls.

The normative consequences of the standard model are well known and assign a strong role for the center. The distribution function and the stabilization function, using the terminology of Musgrave, must be centralized. In the allocation function, public goods should be centralized in areas with strong externalities and economies of scale and homogenous preferences across nations/ regions. The case for decentralization is really to realize allocation gains for local public goods. Given this approach, the obvious follow up in the EU context is to discuss the arranging of allocation, stabilization and redistribution functions at the EU level as in Tabellini (2003).

Fiscal discipline and accountability are built into standard theory. In practice, all countries struggle with the control of decentralized spending. So the snake has entered paradise, but how? Already the basic model allows for central government grants to internalize externalities between decentralized units. Boadway and Flatters (1982) show how grants can correct for imperfections in mobility due to congestion. The desire to establish insurance against shocks also constitute an argument for grants (Persson and Tabellini, 1996). Even more important in practice are issues of tax design. Benefit taxation for local public goods is best achieved by property taxation. But property taxes hardly anywhere generate revenue above 2-3 % of GDP. Other taxes are further away from the principle of benefit taxation and there are few 'good' local tax bases anyway. The central government therefore typically adds funds from broader tax bases like the

value added tax and the income tax. It is important to notice that already efficiency considerations imply central government funding of locals and consequently vertical fiscal imbalance.

The other important reason for central government funding of decentralized government spending is distributional concerns. Local governments have varying (private) income levels and tax bases differ, and grants are introduced for tax equalization. In theory equalization can be arranged at the individual level, but in practice regional equalization also is made through local governments. The desires for equalization from the center are often broader and follow since spending typically is not restricted to local public goods. Equalization of spending is designed in complex grant systems taking into account factors affecting service demand such as the age composition of the population and local cost factors such as the settlement pattern and population size. They are typically distributed as block grants. But many governments use a variety of earmarked grants to stimulate particular services desired from the center.

Vertical fiscal imbalance seems hard to avoid in practice. All EU countries have decentralized government and finance a rather large part of decentralized spending with central government funds. Benefits are enjoyed at the local level, but are at least partly financed from a common pool of national resources. Careaga and Weingast (2000) call such revenue sharing for a 'fiscal pact with the devil'. They put the attention to the political and institutional framework of fiscal federalism that can generate incentives for good or bad governance. The common pool problem implies a spending pressure towards central funds

and also possibly strategic or opportunistic behavior, in all a bias to overspending.

Interestingly, McKinnon and Nechbya (1997, p.55) see more emphasis on equity as the major threat, even ‘the beginning of a slow collapse of the relatively successful US federal system into a unitary state’.

The essence of the common pool problem within nations is that the perceived costs of public services at the local or district level are lower than the actual costs. The services offered by the local public sector supply benefits to specific geographic areas, here called districts. While the benefits are concentrated, the financing is shared through central government taxation distributed out as grants. The benefits are fully internalized in each district, but they contribute only to a share of the financing. The districts consequently impose negative externalities on each other. This understanding of overspending bias was suggested by Tullock (1959) and developed by Buchanan and Tullock (1962) and Weingast, Shepsle and Johnsen (1981) in the context of the US Congress. In the extreme case, each district’s spending is financed out of a common pool of national tax revenues. As shown by Persson and Tabellini (1999, section 9), the common pool problem in this case can be described as the situation where each district sets the local service production with the tax rate determined residually.

The ability to internalize these externalities and control overspending depends on the institutional and political characteristics of the country. Weingast (1979) develops the universalism theory of collective behavior, and the assumption is that all districts are represented in a national legislature. Under a ‘norm of universalism’ all representatives are

members of the winning coalition. The norm is a result of a fundamental uncertainty facing the representatives. Will they be in, or out, of the winning coalition? The uncertainty is removed under the norm of universalism. Compared to a winning coalition that includes less than all representatives, the benefit to each member of the coalition is reduced. However, a small but certain benefit may be preferred to a larger but uncertain benefit.

Weingast et al. (1981) have not developed a full political equilibrium, and recent theoretical research has addressed the decision making within legislature when projects with concentrated benefits are financed by universal taxation [see Chari and Cole (1995) and Persson and Tabellini (1999)]. In the setting of a multi-party parliamentary system with proportional representation from districts, the parties will to some extent internalize the costs of decentralized spending, thereby limiting universalistic behavior and the negative consequences of centralized financing and vertical fiscal imbalances. But when the parties have their strongholds in different regions and have different marginal districts, they will not agree about the geographical distribution of funds. In this setting the party composition of the parliament is the crucial determinant of political strength to hold back the spending pressure

The common pool challenge to fiscal indiscipline is not limited to situations with serious vertical fiscal imbalance. The key point is that indiscipline results when the center holds a soft budget constraints towards the locals and hands out (marginal) funds with discretion. The excess spending bias consequently is the result of lack of commitment to a hard budget constraint. The design of fiscal responsibilities, the working of the political

system, and the commitment problems all influence the degree of internalization. The lessons made about the working of different political systems and fiscal restrictions in this respect, to be discussed below, offer some guidelines for the design of political institutions at the EU level.

3. Empirical evidence of common pool and vertical imbalance

The understanding of the common pool problem in fiscal systems has been developed and investigated empirically in the context of the US Congress. Inman (1988) and Inman and Fitts (1990), analyzing federal grants and federal spending in the US, represent the first econometric studies of the universalistic model. They show the importance of majority-rule leadership in Congress and a strong president to set the agenda and coordinate the national policy. This is the broad lesson for political design. An agenda-setter is needed to overcome the geographical interests.

The analyses available relevant for European countries and political systems have mostly taken a broader view of the fiscal challenge. Perotti and Kontopoulos (2002) address fragmented fiscal policy in OECD countries and analyze the political side of the common pool problem as a relationship between the number of decision makers and the size of government. The size fragmentation is measured as number of parties in the ruling coalition and number of spending ministries. They follow an extensive empirical literature of the effects of political structure and political fragmentation started up by Roubini and Sachs (1989). The broad conclusion from this literature at the country level is that political

fragmentation tends to lead to larger government size and that the common pool problem is an important background factor. More recent studies, notably Hallerberg and Hagen (1999), extend the analysis to electoral institutions, which is a background determinant of political fragmentation.

The relationship between decentralization of government and government size has been investigated in light of the hypothesis that competition leads to smaller government (Brennan and Buchanan, 1980). The empirical studies following Oates (1985) are not able to establish that decentralization holds back government size. Kirchgässner (2002) surveys the arguments and estimates. The hypothesis that decentralization implies common pool problems and generates larger government has been studied for Latin-American countries in a research project at the Inter-American Development Bank. The project emphasizes vertical fiscal imbalance and other aspects of intergovernmental relations that may give rise to soft budget constraints. Stein (1999) concludes that decentralization tends to produce larger governments, and in particular when vertical fiscal imbalance is high, central government grants are discretionary, and local borrowing autonomy is large. Interestingly, vertical fiscal imbalance here is a level effect and not limited to marginal funds.

Expansion of the local public sector over time has been studied in the same perspective. Borge and Rattsø (2002) analyze the fiscal federalism design in Norway in an econometric analysis of growth of local public spending during 1880-1990. The benefits of decentralized government spending are concentrated to each municipality and county,

while the costs to a large extent are carried by general taxation and distributed as central government grants. The party fragmentation of the parliament is the main determinant of the political strength to internalize costs and thereby contribute to a socially efficient allocation in this system. Party fragmentation of parliament is measured by a Herfindahl index, and has a significant impact on decentralized spending growth. Two other indicators of political strength, capturing type and duration of government, are shown to have similar effects. Internalization of costs seems to be a serious challenge to the national political system under vertical fiscal imbalance. The asymmetry between decentralized spending and centralized financing contributes to public sector growth.

Experiences at the local government level offer broader databases for empirical testing. Direct tests of the relationship between districting and government spending are hard to do, since most political systems are more complex. City councils across US city governments come close theory and are analyzed by Baqir (1999). The size of the city councils is determined by their districting, and redistricting is not a very frequent event. The analysis of US cities confirms that larger city councils are associated with larger government expenditures per capita. The effects of districting are estimated in a demand model of city government spending, and the main result seems to be robust to alternative econometric approaches and alternative measures of spending. The quantitative effect is of economic interest, since adding one district on average raises per capita spending by 3%.

Outside the US district representation, empirical measures of the common pool problem is harder to find. An analysis of high school spending by county governments in Norway gives some indirect evidence (Falch and Rattsø, 1999). The high schools offer benefits to each municipality such as employment and higher local tax revenues. Also the presence of a high school reduces student commuting and may increase enrollment. It follows that municipalities can obtain benefits from a common pool when the costs are shared within the county. In this study, the average population size of the municipality is a measure of the common pool effect. Many small municipalities are assumed to have the same effect as many districts. School spending is disaggregated to separate between the sources of variation in teacher-student ratio, non-wage spending per student, and student enrollment. In the estimated demand model of county level school spending, the average size of the municipality has a clear impact. Resource use per student goes up when the average population size of the municipalities is reduced. The municipalities seem to be successful in influencing the number of and the location of high schools determined by the counties. The teacher-student ratio increases because smaller schools mean smaller classes, and non-wage spending increases because more schools mean more administration and maintenance per student.

The database on high school spending allows simultaneous analysis of the common pool effect and political institutions. While average size of municipalities measure spending pressure, political strength affects the ability to hold back the pressure. Political strength is measured by type of government a la Roubini and Sachs (1989), separating between majority and minority and one party versus coalition, and by a Herfindahl index of party

fragmentation of the county councils. Falch and Rattsø (1999) apply interaction terms between municipality size and political strength, and the estimates show that spending pressure is most effective in counties with weak political leadership. The effect of municipality size on student enrollment is strong and depends critically on political strength. In weak county councils, smaller municipalities increase resource use per student at the cost of student enrollment, while strong county councils are able to increase student enrollment.

We conclude that multiple layers of government represent a challenge for fiscal discipline. The intergovernmental relations vary across countries with different assignments of responsibilities, different sources of financing, and different economic and political autonomies at the levels involved. Whatever institutional setup, it is hard for the center to commit to hard budget constraints. At this stage, the EU experiences limited common pool pressure for agricultural and structural funds. Establishing fiscal autonomy at the EU level will generate more spending pressure, since country governments can obtain more at the center. This represents a challenge for the design of EU decision making authority to operate its fiscal autonomy, but also may change the fiscal behavior at the country level as the costs of public spending programs can be shifted between countries.

4. Intertemporal imbalance: Deficit shifting

Oversized government can be understood as the result of the static common pool problem discussed above. The associated concern for stabilization and deficit bias requires an extension into dynamics and mobility. The essence of the fiscal federalist model is that households and firms can move between jurisdictions. The competition for households and firms and the threat of exit are important disciplining devices on fiscal performance. In the EU context, the mobility also can be a source of concern, both for debt and deficit control and for the assignment of responsibilities within the union.

The main worry is fiscal decentralization as a source of fiscal crisis. Excessive local deficits and debts may generate overall fiscal imbalance and with high social costs. The mobility of households represents an incentive for deficit financing. If local governments borrow to finance current spending, the costs are shifted to future taxpayers. Households may see this as an attractive financing alternative, because they can move out before the bill is paid. At best, private credit markets will evaluate the creditworthiness of the local governments and stop the borrowing spree in due time. The problem here is the possible mechanisms of soft budget constraint for the central government. The central government can hardly be passive when local governments default and financial markets and local taxpayers suffer. The expectation of central government bailout will encourage further local deficits and debt. It should be noticed that such deficits may appear in complicated ways like pension underfunding.

Inman (2003) clarifies the conditions for 'deficit-shifting' and studies more closely the exceptions to the US success of fiscal discipline, notably the recession in the 1930's and

more recent big city crises (like New York City, Washington DC, Philadelphia and Miami). He identifies institutions promoting fiscal discipline, in particular powerful presidents, constitutional balanced budget rules, and fiscal oversight boards. His major conclusion is that ‘this tradition of refusing to provide significant national fiscal relief to governments in distress continues to this day’.

The deficit bias of decentralized government inherent in fiscal federalism necessitates institutional restrictions on local behavior to avoid moral hazard. All countries with decentralized government have put restrictions on the locals, although in various forms and strength. Balanced budget rules and limits to borrowing are the two main instruments of control. Recent country studies of constraints and their performance are offered by Ter-Minessian (1997) and Dafflon (2002). Country studies of bailout mechanisms and experiences are collected in Fernandez-Arias et al. (2003) and Rodden et al. (2003). In principle, fiscal discipline can be taken care of by market constraints, political constraints or administrative constraints. Private credit or land markets can discipline local governments only when the locals have full economic autonomy. US states and Canadian provinces seem to be the only decentralized units where market discipline plays an important part. We are then left to the combination of political structure and administrative regulations to secure discipline.

Most of the empirical literature analyzes aggregate measures of fiscal imbalance in cross-country studies following Roubini and Sachs (1989). Alesina and Perotti (1995) summarize the fiscal consequences of a variety of aspects of the political system in OECD

countries. The main conclusion is that political fragmentation is associated with fiscal deficits. Weak governments lead to deficits as well as government oversize because they are unable to internalize costs. The effects of intergovernmental fiscal relations on fiscal balance are less clear. Mello (2000) relates both central and local government fiscal balance to measures of tax autonomy and vertical fiscal imbalance in a cross-country study. Local tax autonomy (local taxes high share local revenue) tend to worsen fiscal positions both for the locals and the central government, and the consequences of vertical imbalance (grants high share of local revenue) are mixed. Interestingly, restrictions can be understood as the result of the intergovernmental relations. Von Hagen and Eichengreen (1996) test the relationship between vertical fiscal imbalance and borrowing restrictions in a dataset of 45 countries. They find econometric evidence that centralized financing is associated with borrowing controls. They also find that countries with borrowing restrictions have higher government debt. The understanding is that the fiscal pressure against the center is higher when the center controls the funds.

Studies of fiscal restrictions at the local government level are hard to do since most countries have common rules for all local governments. There is no variation in regulations to take advantage from. The European case studies edited by Dafflon (2002) show that countries apply different forms of restrictions to budget balance and borrowing. All allow for administrative discretion at the central government level, and all struggle with local authorities attempting to get around the restrictions (typically off-budget activities). Restrictions seem to work although they are imperfect. The episodes of local fiscal crisis experienced, notably in Italy and Spain in the late 1970s, motivated an

overhaul of the fiscal controls. Central government interventions and bailouts were followed by institutional reforms to avoid future repetitions. Many contributors to Dafflon's volume report that the EMU process has been helpful in arranging sustainable balances.

More extensive econometric studies of the consequences of budget balance requirements and borrowing limitations are made for the US states. The US states with their relative homogeneity and institutional variation offer an attractive database for the investigation of fiscal restrictions. The states generally have balanced budget requirements and limitations on debt, but in different forms. Von Hagen (1991) did an innovative study of how these rules affect state indebtedness. The motivation for his study was the discussion about European monetary integration and the use of fiscal restraint. The US case represents an opportunity to investigate how fiscal restraints in a monetary union are functioning. His main conclusion is that fiscal restraints 'do little to reduce the likelihood of extreme outcomes in fiscal performance' and thus that they cannot be expected to be effective in a European monetary union.

Poterba (1997) summarizes the many studies available about US states and classifies three main types of regulations: Required submission of a balanced budget; required legislative decision of a balanced budget allowing for actual deficits; combining a balanced budget from the legislature with a prohibition to carry forward the deficit. The empirical analyses apply an index of the stringency of the state's balanced budget requirements. Most contributions estimate broad models of economic and political

variables affecting spending and revenue behaviour. The analysts agree that the most restrictive fiscal limits do reduce the state indebtedness and also reduce the borrowing costs for a given deficit.

In the EU context, the experiences point in two directions, either an integrated European public sector or formal restrictions from the center. The stability pact can be interpreted as fiscal restrictions established to respond to underlying common pool problems. The lessons above indicate that such restrictions only work when they are part of a well-functioning and robust political decision making system. The challenges already observed to the stability pact reflect the weak political backing of the restrictions.

5. EU fiscal federalism consequences

According to the principles of fiscal federalism (the Musgrave-Oates-Tiebout-model), there is a case for EU economic centralization of public goods and redistribution as well as macroeconomic policy. Tabellini (2003) argues for an array of responsibilities assigned to the European level of government. Public goods should be centralized in areas with strong externalities and economies of scale and homogenous preferences across nations/ regions. External and internal security and infrastructure/ transportation are obvious candidates for EU provision. One of the defining characteristics of fiscal federalism is the availability of independent taxation at all levels of the federation. There are two arguments for EU level taxation, First, the present cost-sharing arrangement does not encourage an efficient public goods level and will be cumbersome to handle as the

budget expands. From a fiscal point of view, the costs of public goods provision should be internalized at the level of the producer. Second, there are separate efficiency arguments for EU level taxes such as environmental taxes and capital taxation. These are taxes with international spillovers and therefore hard to handle at the national level.

Beyond the allocation efficiency case for EU level public finance, also Musgrave's distribution function and stabilization function are candidates. They open a new territory of potential fiscal indiscipline. The budget of the EU today is basically redistribution, linked to structural funds and common agricultural policy. The case for extended redistribution concerns both permanent transfers to poor regions and insurance to handle negative shocks. Redistributive policies including welfare systems also may involve spillovers and scale effects. Bertola et al. (2001) discuss strengths and weaknesses of alternative arrangements of welfare policy and they argue for EU-level policies. The macroeconomic argument for fiscal policy is based on the need for automatic stabilization (and possibly active fiscal policy) to complement the monetary union. Community policy to handle regional stabilization has both a macroeconomic and a distributive aspect.

The more recent literature on fiscal competition strengthens the economic arguments for centralization. Economic integration and mobility changes the conditions for the assignment of responsibilities in a fiscal system. Fiscal competition among nation states tends to reduce the ability to arrange redistribution and welfare policy at the national

level. Sinn (2003) argues that increased factor mobility incurs the risk of dismantling the welfare state. The EU level can compensate this loss of fiscal strength nationally.

There is an alternative theory of competitive federalism where decentralization is a mechanism to constraint the center. Brennan and Buchanan (1980) describe a center seeking to maximize public revenue and exploiting citizens ('Leviathan'). The strength of the center consequently is a major source of fiscal inefficiency. Federalism is a way of reducing political power. It allows an exit option for the citizens and will constrain excessive government. Fiscal competition is a favorable mechanism of control and should be encouraged (or rather constitutionalized). Oates (2001) develops the understanding of fiscal competition in the EU context. He is worried that the present public finance structure is ill-suited to handle the redistribution and stabilization functions.

The lessons made of decentralized government indicate a danger of centralization. Establishing a super-national center may create new sources of fiscal indiscipline. Economic centralization changes the fiscal constraints of the national level. National governments may start chasing funds from above. They get a 'big brother' to ask for grants and bailout. The common pool challenge easily shows up in federalist structures.

The case for economic centralization must be balanced against the mechanisms of fiscal discipline outlined above and handling of democratic decision making. Continuation of the present fiscal confederation or cooperative federalism represents a minimum solution for EU level public goods financed by contributions from member states. The design

assumes that national governments agree about public goods provision and leaves little room for independent central government. It is hard to think of welfare and distributional policies developed much in this alternative. The key argument for confederation is avoidance of a center that opens up the problems of fiscal indiscipline at the national level.

Given a single market and one money, and with fiscal competition as discussed above, the natural economic implication is to have broad based fiscal policy at the EU level. It can be argued that bottom-up federalism of this kind has an advantage to top-down decentralization, since vertical fiscal imbalance can be limited. When decentralized governments are established, the starting point is a center with own tax financing and often with a stronger case for decentralizing spending than taxation. The design of a new EU level fiscal system can be made with spending authority matching taxing authority. But even without vertical imbalance, the existence of funds at the center is sufficient to soften the budget constraints at the national level. The lesson from local public finance is that a broad EU fiscal policy opens up for the possibility of redistribution games and expectations of bailout. The decision making system must be arranged to attempt at safeguarding against soft budget constraints. This is difficult in particular when politics is geography based as in the EU.

The EU challenge consequently is to balance economic and political centralization. A continued weak center will probably lead to underprovision of public goods and leave a demand for redistributive arrangements and stabilization policy. On the other hand, a

strong center with extensive fiscal responsibilities may threaten the autonomy and independence of the national governments. The sources of fiscal indiscipline discussed above indicate that the intermediate situation of weak center with broad fiscal mandates is the worst case. The US Constitution solution was to design a central government with broad fiscal assignments and at the same time constraints to central government behavior and autonomy at the state level. It is not obvious that the center will act as a benevolent planner. There is a democratic challenge in addition to the establishment of economic and political authority.

The stability pact set the macroeconomic conditions for a well functioning monetary union. The common pool challenge involved results from the possibility of individual country fiscal deficit financing from common savings funds and that the consequences for the EU wide financial markets are not internalized. The practicing of such restrictions and the avoidance of fiscal indiscipline requires a strong center committed to hard budget constraint. The weak EU level alternative may be difficult to sustain when single market and one currency are to be managed.

The relationship between economic and political centralization is discussed by Blanchard and Shleifer (2001) in their comparative analysis of federalism and economic growth in China and Russia. The strong central government in China disciplined the local governments into promoting growth, while a weak center explains why local governments were captured by old rent seekers in Russia. 'Without such centralization, the incentives to pursue regionalist policies are too high, and cannot be eliminated solely

through clever economic and fiscal arrangements' (Blanchard and Shleifer, 2001, p. 178). This view is challenged by Figueiredo and Weingast (2001) in a discussion of the 'two fundamental dilemmas of federalism'. Political centralization is seen as necessary to prevent locals from undermining federalism through common pool behavior. But they emphasize another dilemma, that the central government must be prevented from destroying federalism by extracting rents from the locals. The controversy is rooted back in the discussion about the US Constitution: The Federalists wanted a strong center for national defence and policing common pool problems, while the Anti-Federalists were worried about abuse of power towards the states.

6. Concluding remarks

Based on the experiences in local governments, we have shown how the common pool problem appears in fiscal systems when spending and benefits are separated from financing and costs. Design of financing towards benefit taxation is the first recommendation that comes out to avoid overspending bias. Since this is hard to achieve, the next challenge is the design of the political decision making to promote internalization of costs. Political fragmentation is a threat to internalization and therefore excess government spending and deficit. Since politics tends to involve redistribution and democratic institutions represent conflicting interests, fiscal restrictions to impose fiscal discipline are necessary too. The standard configuration includes a combination of balanced budget rules and borrowing controls, and a hardening of institutions to avoid

bailout and associated moral hazard. The weakness of the center comes out as a key concern.

The fiscal federalism challenge in the EU is to establish the center, and bottom-up federation presumably has an advantage in fiscal discipline compared to top-down. Confederation is a continuation of the present cost-sharing budget among the members. A weak center is combined with strong nation states. When independent taxing authority is established at the EU level, a defining characteristic of a federation, the budget constraints at the national level may soften even if the central funds are small initially. If the fiscal system is extended to include insurance oriented redistribution and fiscal policy to complement the monetary policy, a strong central government is certainly needed. A strong center is a prerequisite of a well functioning fiscal federalism. The intermediate situation of weak center with broad fiscal mandates is the worst case

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