Budgetary Pressures in the EEC: A Fiscal Federalism Perspective

By DAVID E. WILDASIN*

As is widely known, the EEC has gone through some troubling budgetary difficulties in recent years. Disputes have revolved around the growth of agricultural subsidies and about the contributions to be made to the EEC by various member countries; in particular, the U.K. These problems have been brought under control for the short run. However, the implementation of the Single European Act could be greatly complicated, and might falter, if policymakers again became intensely involved in acrimonious budgetary disputes. Maintaining budgetary control for the next several years, and for that matter in the longer term as well, is thus a matter of considerable tactical importance within the context of the overall progress of European economic affairs. In view of the fact that the threat of acute budgetary crisis has receded somewhat, and in view of the prospect of a significant step forward toward more complete economic integration associated with the 1992 initiative, it seems appropriate to give some thought to the budgetary problems that the EEC is likely to confront in the medium term.

At a time of enormous political change in Eastern Europe, it is exceptionally hazardous to attempt projections about economic affairs in the EEC. It is easy to visualize scenarios in which significant amounts of resources, whether from the EEC itself or from individual member states, are directed toward promoting economic and other reform in the East, forcing new choices with respect to the commitment of resources by member countries to the EEC. However, to limit the scope of this paper, attention is restricted to developments within the EEC itself.

The major trends in the EEC budget are easily delineated, since only a few main initiatives account for the bulk of EEC expenditures. First, agricultural subsidies through the European Agricultural Guidance and Guarantee Fund (EAGGF) have entailed large expenditures. Through the 1980s, these outlays accounted for about two-thirds of EEC expenditures. Another major category of EEC expenditures are for the so-called "structural funds," in particular the European Regional Development Fund (ERDF) and the European Social Fund (ESF). The ERDF funds economic development projects in specially targeted low-income regions. The ESF funds programs that promote the training and employment of workers, especially youth and long-term unemployed persons. These and related expenditures have accounted for about 10–15 percent of expenditures during the 1980s. Altogether, then, agricultural and structural expenditures account for about 85 percent of the total budget. The U.K. has repeatedly protested against what it regards as excessive contributions to the EEC relative to the return that it gets in the form of structural fund outlays, and it has garnered a partial rebate of its contributions to the EEC, equal to two-thirds of the difference between the U.K. VAT contribution and EEC expenditures allocable to the U.K. These rebates account for roughly 5 percent of the EEC budget.

As a result of decisions taken in 1988, the outline of the EEC budget for the next sev-

[†]*Discussants*: Paul Courant, University of Michigan; Rudolph Penner, The Urban Institute; John Yinger, Syracuse University.

*Department of Economics, Indiana University, Bloomington, IN 47405. I am grateful to the Department of West European Studies at Indiana University for support of my research. A longer version of this paper is available on request.

eral years is relatively clear. The special arrangements regarding U.K. contributions are to remain essentially intact. The growth of EAGGF expenditures is to be limited while ESF and ERDF expenditures are to be doubled (in real terms) by 1992. Expenditures on agricultural guarantees should fall to about 55 percent of the total budget in 1992, while expenditures in the structural funds will rise to about 25 percent. A notable feature of the evolving EEC budget is the extent to which it has focused resources on redistributional policies. For example, the expenditures in the structural funds are explicitly geared toward assistance in low-income areas of the Community.

For the purposes of budgetary analysis, the EEC is usefully viewed as an emerging federation. The EEC institutions can be seen as a central governmental agency that obtains resources from lower-level governments (the member states) and expends these resources through a system of grants. As we have seen, most of these grants support programs with redistributional objectives. Familiar principles of fiscal federalism assert that redistribution in a federal system creates externalities that warrant intervention by a higher-level government through appropriate grant policies or a complete shift in the responsibility for redistributive activities from lower- to higher-level governments. (See Richard Musgrave, 1969, and Wallace Oates, 1968, 1972.) Thus, it is not surprising to see the EEC budget evolving along the lines that we have observed. However, these redistributive activities deserve more thorough consideration. This paper outlines two simple models which can be used to analyze EEC expenditures, focusing on the economic and political linkages within and among the member states. I argue that these linkages can play a critical role in determining the impact of EEC grants.

I. Two Models of Redistribution with Spillovers

A. *A Model with Altruistic Spillovers*

In all European countries, governments undertake substantial economic interventions that favor particular regions, industries, or occupational groups. These programs constitute a bundle or package of assistance that implies some set of net transfers from the rest of the country to particular industries or regions. Think of these policies as the equilibrium of some political process. EEC grants perturb this equilibrium. What is the nature of the response?

Let us focus on a particular region in a country that will be the target of assistance from the ERDF for, say, a water project. Imagine an initial equilibrium in which individuals both within and outside the region contribute (through taxation) to the provision of public goods and services that benefit the region, with those not residing in the region benefiting from these policies because of presumed "altruistic" motives.[1] Treat all households within the region as a single representative individual, and let those outside the region be similarly aggregated. Suppose that each group sets its level of contribution to public goods provided within the region taking the other's contribution as given. This is most easily visualized if there is a lower-level government in the region through which the residents of the region can explicitly vary their own contributions to public goods independently of the national government, which will be assumed to ease the exposition. However, all that matters is that the political process, even if centralized, works *as if* this were the case. (In Oates' 1972 terminology, the model requires economic but not political decentralization.) Under these assumptions, we can apply the results of recent analyses of equilibrium models of public good provision by several agents (see Theodore Bergstrom et al., 1986, and Robin Boadway et al., 1989).

In conventional models of intergovernmental grants, a recipient government is

[1]To avoid semantic confusion, note that this "altruism" need not be inconsistent with a fairly narrow conception of self-interest. Self-interested individuals may wish to commit the public sector to interventionist policy rules in order to provide social insurance. (One is reminded of H. L. Mencken's remark that "altruism, when analyzed, always turns out to be self-interest in a long-tailed coat.")

treated like an individual household, and grants are viewed as a parametric change that alters the budget constraint facing the jurisdiction. Models of this type are not properly applicable, however, to situations like the present one where the recipient government and some other government are simultaneously contributing to a common public good. In the case we are considering, suppose that both the regional authority and the national government would spend resources on water projects in the absence of any ERDF grant. Then, if the grant is lump sum in form, the model predicts a reduction of national spending on water projects in the region. Because of the initial linkage between the region and the rest of the country through the national government, the grant provided to the regional authority is fully fungible with the resources of the national government, and its real impact is identical to a grant of equal size to the central government. Spending on the water project by the regional authority is predicted to remain nearly constant while national government spending on water projects in the region should fall by nearly the amount of the grant. (Since grants do not reduce spending by the regional authority on the aided function, the model implies large "flypaper effects".) Total spending from all sources on water projects in the region would thus remain roughly constant. If the grant is of a matching type, it will be offset by even greater reductions in national government spending on water projects, and it will be accompanied by a larger increase in spending by the regional authority.

If the national government does not provide resources directly for water projects in the region, but does provide funding for, say, agricultural programs, the effects are analogous. If agricultural projects are highly substitutable for water projects, then the essential fungibility of resources is preserved, and the only difference is that the national government responds by cutting back its spending on agriculture.

Thus, the real distribution of gains from regional grants may be quite different from the apparent distribution. When a region is the beneficiary of public goods that are provided partly at the expense of other households in the country, an EEC grant may lead to reductions in support from the national government. As an example, the real beneficiaries of EEC grants to an impoverished region (or industry, etc.) in Scotland might in the end be the average U.K. taxpayer. Indeed, the painfully negotiated reductions in the U.K. contribution to the EEC budget reflect precisely this sort of logic, since it links the U.K. contribution to EEC expenditures on behalf of the U.K. This implies a willingness by the U.K. to increase its contribution to the EEC budget if it receives enough of those contributions back in the form of ERDF, ESF, or EAGGF benefits, but not otherwise, testifying to the political fungibility of resources obtained from the structural funds with those in the hands of the Chancellor of the Exchequer.

This analysis puts the structural funds in quite a different perspective than would be the case if the regions (or industries) were viewed as fiscally unconnected with other areas of the countries in which they are located. It indicates that the expenditure and revenue sides of the EEC budget are linked, and suggests the importance of thinking about the effect of the structural funds on the net fiscal position of the member states in addition to their purported functions of promoting economic development and employment in rural, declining, and poor regions and industries. Such a perspective is consistent with the approach taken by Mervyn King (undated) and Tommaso Padoa-Schioppa et al. (1987), who emphasize the need for "equitable" determination of contributions to the EEC budget, defined in terms of a country's contributions *net* of EEC expenditures in the country. As long as the programs supported by the EEC are also important functions of the member states, high substitutability between structural fund allocations and contributions must be expected. This implies that the welfare effects of these programs cannot be properly assessed in an institutional vacuum that treats other member state public sector programs as exogenously determined. Furthermore, the political pressures and constituencies that shape EEC policy are presumably highly dependent on the real distributions of gains and losses from them.

B. *Migration Spillovers*

Migration of factors of production creates another form of linkage among countries in the EEC. The nature of labor migration, and the policy issues that it poses, are likely to vary over time and space. Since migration barriers of all kinds are falling over time, these issues can be expected to grow in importance.[2] In particular, as has been emphasized in the literature, redistributional activities in one jurisdiction can produce externalities for others when migration occurs. Here I use a model that seems well suited to the analysis of redistributive activities when several jurisdictions are linked through an integrated market for some but not all types of labor. This model can be used to represent a world in which some household types find migration very easy and others find it quite difficult, which may be a particularly useful characterization of the EEC situation of partial but perhaps still limited integration of the overall labor market.

Specifically, consider a simple model where households are divided into two groups: those who are costlessly mobile and those who are completely immobile.[3] Mobile households choose locations so as to maximize income inclusive (or net) of any subsidies (or taxes). They are paid wages equal to their marginal products wherever they reside. As a condition of equilibrium, $w_i + z_i = c$ for any country i that contains mobile households, where w_i is the wage (marginal product) of mobile households in country i, z_i is a lump sum subsidy (or tax, if negative) paid to (imposed on) these households in country i, and c is the common level of net income for mobile households in other countries. All income in each country net of the wages of mobile workers accrues to the immobile households residing there. These households are assumed to control the political process in each country and to care about the welfare of the mobile households (i.e., c enters their utility functions). (As examples, think of the immobile households as rich and the mobile households as poor, or as old and young.) Because immobile households do care about the welfare of the mobile, they will either provide them with subsidies or at least will not tax away all of their income.

The important point is that the equilibrium value of c is influenced by policy choices in all countries. Subsidies to mobile workers in one country attract more of them and benefit households in other countries because of the increase in c and through a reduction in the fiscal burden of supporting mobile households. This positive externality can result in inefficiency. If each country carries out subsidies to the point that is optimal from the viewpoint of its own immobile residents, taking as given the policy of other countries, there will be underprovision of benefits to mobile households. A matching grant from the EEC would help to correct this inefficiency. In the special case where there are n countries with identical preferences, endowments, and identical technologies, the matching rate that would correctly internalize the externalities associated with support for mobile households satisfies

$$(1) \qquad s = 1 \Big/ \left(1 + \frac{1}{\varepsilon}\frac{n}{n-1}\frac{w}{z}\right)$$

where ε is the common elasticity of demand for the labor of mobile households (defined to be positive) in each country and w and z are the common wage and subsidy rates in the symmetric equilibrium. Provided that $z > 0$, the optimal subsidy rate s lies between 0 and 1. (This formula can be used to

[2] It is of interest to note that residents of East Germany need only cross into West Germany to claim citizenship in the BRD, and with it the right to EEC passports. The EEC labor market has thus effectively expanded, creating a rather odd situation where East Germany is not a member state of the EEC, but its residents can claim the rights to which residents of any member state are entitled, provided only that they migrate to the West.

[3] This model is discussed in more detail in my 1990 paper. The framework of the model is closely related to that found in Boadway and myself (forthcoming). The division into mobile and immobile household types parallels my 1983 article.

derive illustrative calculations of the optimal subsidy.)

The formal analysis of this model is essentially the same when the mobile group is taxed rather than subsidized by immobile households.[4] Thus, it could be applied to the analysis of taxation of wealthy mobile households by relatively immobile poorer households. In this case, there is a beneficial externality rather than a negative externality associated with migration: a taxpaying household entering a country adds a fiscal surplus rather than a fiscal burden. There is thus an incentive to tax mobile households too lightly, or to underspend on public goods, which could be offset by appropriate EEC policies.

This analysis suggests that the externalities associated with redistribution, either through income support systems or through taxation, will be exacerbated as labor markets become increasingly integrated. One of the objectives of integration is to facilitate the flow of resources, including labor, to locations where their value is high. Spatial arbitrage is inherent in this process, and in the context of labor markets this implies a tendency toward more uniform net incomes for workers. By its nature, this process implies that the effects of redistributive policies will spill across national boundaries and will be felt throughout the relevant market areas. We thus expect to find increasing pressure on EEC member states to restrict their redistributive policies, as the benefits associated with redistribution at the national level fall and the costs increase.

It is clear from the official literature of the EEC (including the Single Europe Act itself) that high priority is attached to insuring that no major groups suffer serious harm as integration proceeds. To the extent that national redistributional policies come under pressure from increasing labor market integration, one is thus likely to see expansion of redistributive policies at the EEC level—as, for example, in the doubling of the budgets for the ERDF and the ESF in the run-up to 1992.

II. Conclusion

Jacques Delors, President of the European Commission, has written that, "[a]pplying the logic of Musgrave,...a more effective allocation of resources at [the] Community level...calls for a strengthening of the redistribution function" (1987, p. *vi*). The models considered in this paper highlight different aspects of the political economy of EEC budget policy related to redistribution. The first has emphasized the potential fungibility of structural fund expenditures within member states arising from their internal political linkages, focusing attention on net fiscal transfers among member states. The second has emphasized that increasing market linkages among countries resulting from economic integration may limit the amount of redistribution undertaken at the national level in the EEC, and that this may create pressures for increased redistribution at the EEC level.

As the budgetary difficulties associated with the U.K. contributions have shown, these two considerations are not independent of one another. A significant barrier to increased redistributive expenditure at the EEC level is a concern on the part of member states that the benefits from these expenditures may be captured by other countries. The limitation on U.K. contributions is *ad hoc* in nature, and leaves the general problem unresolved. Broadly speaking, what is needed is a budgeting mechanism that provides for burden sharing that is "equitable" in that it constrains expenditures to bear a reasonably close relationship to national contributions, while providing for expenditures that promote activities generating substantial spillovers. The recent budgetary accords appear to represent progress in this direction, but budgetary issues are likely to be reopened as the EEC adapts to a rapidly changing political and economic environment.

[4] What matters for locational incentives is the totality of all resident-based fiscal instruments, including capital taxes assessed at the individual level as well as taxes on wage income. Paul Courant (1987) discusses the issue of tax reform in several European countries, noting that marginal tax rates for individual income taxes have recently been falling.

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