

Federalism, Fiscal Autonomy and Democratic Legitimacy in Europe: Towards Tax Sharing Arrangements

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Introduction

Over the last two decades throughout Europe, major changes have taken place in the way public policies are decided upon and implemented. The classic model of government has had to make way for the model of multi-level governance, which implies two things. First, central governments are no longer the dominant actors in most policy arenas. Decision-making competencies are increasingly shared by actors at different government levels rather than monopolized by nation-state executives.¹ Governance nowadays resembles a marble cake, and not simply a layer cake as the different layers are very much intertwined (*Politikverflechtung*).² Secondly, multi-level governance (in this context also referred to as multi-actor governance) implies that government (be it central, regional or local) increasingly is a co-producer of policies together with the private sector, forming policy networks, using public-private partnerships and/or interactive policy-making ar-

1. Cf. Gary Marks, Liesbet Hooghe and Kermit Blank, "European Integration from the 1980s: State-Centric v. Multi-level Governance," *The Journal of Common Market Studies* 34/3 (1996), 341-378.

2. See Beate Kohler-Koch, *Europe and the Regions: The Issue of Multilevel Governance and Sovereignty*, paper presented at the University of Twente, 12-14 February, 1998, applying Grodzins' well-know 1960s US metaphor to the EU. See also Fritz Scharpf, "Die Politikverflechtungs-Fälle: Europäische Integration und deutscher Föderalismus im Vergleich," *Politische Vierteljahresschrift* 26/4 (1985), 323-356.

rangements. More generally, the dividing line between public and private sector has become more and more vague, due to putting parts of the public sector at arm's length of government, or even beyond that.

In Europe, constitutionally and/or by means of treaty arrangements, sovereignty is split between local and regional governments (hereafter: LRGs) authorities, central governments and the European Union (hereafter: EU). An important aspect of sovereignty is fiscal autonomy: To what extent do different levels of government within Europe have the power to tax and/or spend? In most unitary states the power to tax for LRGs is rather limited. Downward-funding schemes are in place to supply these governments with resources and the power to tax rests mainly with central government. In federal states, the power to tax is often split between the different levels of government, which frequently share the same tax base. But even in these cases of considerable fiscal autonomy, fiscal transfers are used between different levels of government, for reasons of equity and/or stability. As far as the EU is concerned, it virtually has no power to tax and depends heavily on upward funding by member states. Although proposals for EU taxes are made on a regular basis by the European Commission (i.e. in the run-up to the adoption of every new EU multi-annual financial framework), and although these proposals are commonly backed by a vast majority of the European Parliament (hereafter: EP), they are always swiftly dismissed by the Council.

In short, the fiscal set-up in Europe, in terms of taxing and spending powers for different layers of government, seems to be cast in iron. This article aims at assessing the implications the lack of fiscal autonomy has for democracy and especially for the legitimacy of the EU. That the link between taxation and representation has always been vital for the legitimacy of government, is shown by various tax revolts in Europe in the 17th & 18th centuries as well as by major events as the American War of Independence (1775-1782) and the French Revolution (1789). It is argued here that tax sharing arrangements between various levels of government could provide a feasible solution, offering increased fiscal autonomy to the EU and to LRGs, while at the same time acknowledging the pivotal role of central governments.

The article is structured as follows. First, some data on fiscal autonomy in practice are presented and discussed. From this analysis, it follows that within Europe, central governments still hold the lion's share of the power to tax and spend and that the whole European fiscal system is heavily imbalanced. Subsequently, the implications of this imbalance for democratic legitimacy are discussed, followed by a review of several theories on federalism (fiscal federalism theory, dual or competitive federalism and cooperative federalism). Finally, the possibility of tax sharing within Europe as a way-out of the current deadlock is discussed. The last section concludes.

Fiscal autonomy in practice

Let us have a look at *taxing power* first. Table 1 below shows the tax shares that different levels of government have in the EU-27. The last row refers to LRGs in both unitary and federal EU states, excluding federal regions, which are listed separately in the table. These federal regions are the *Länder* in Austria and Germany, the *gewesten en gemeenschappen/régions et communautés* in Belgium, and the *comunidades autónomas* in Spain.

Table 1 Tax shares of different levels of government in the EU, as% of EU-27-GDP and as% of total tax and social security revenues in the EU-27 (2008)³

<i>Government level</i>	<i>Taxes as% of EU-27-GDP</i>	<i>Taxes as% of total taxes and social security contributions in EU-27</i>
EU	0.3%	0.8%
Central government	19.9%	50.6%
Social security funds	12.3%	31.1%
Regional governments in federal states	2.8%	7.1%
LRGs	4.1%	10.4%

From table 1 it clearly follows that within Europe central governments (together with the social security funds which are often located at the central level as well) still hold the power to tax.

The EU has a very limited share in taxation, of 0.3% EU-GDP and of 0.8% of total EU-27 tax revenues. This share consists of the so-called own resources: sugar levies as part of the Common Agricultural Policy, customs duties as part of the Common Trade Policy, and a share in the VAT-revenues of member states. As far as the first two revenues are concerned (the so-called traditional own resources) the EU has the power to set these levies and duties (in terms of tax base and rates as part of these common policies). It is however arguable whether the third own resource (VAT-share) in its present form really constitutes an 'own' EU resource.⁴

3. Author's own calculations based on: European Commission, *Taxation trends in the European Union, 2010 edition* (Luxembourg: Publications Office of the European Union, 2010).

4. Although heavily harmonized as far as the tax base is concerned, the VAT is still a national tax, with differences in rates between member states. In terms of tax sharing, which is discussed below in this article, the sharing of the VAT base is not a true example of joint taxation.

LRGs have a share of only 17.5% in total tax revenues.⁵ And even then it is questionable whether these shares as such truly express taxing power, in terms of being able to make decisions on tax bases and tax rates. In table 2 this discretionary power over bases and/or rates is taken into account. In half of the countries listed in the table, limited discretionary power over tax bases and rates further decreases the – already low – taxing autonomy of LRGs.

Table 2 Power to tax of LRGs in some unitary-European countries (2005), excluding tax revenues from tax sharing⁶

	<i>Taxes of LRGs as % of GDP (a)</i>	<i>% of LRGs taxes for which LRGs have full discretionary power to set tax bases and/or tax rates (b)</i>	<i>Power to tax (a) * (b)</i>
Sweden	15.9%	100%	15.9
Denmark	17.1%	91%	15.6
Finland	9.1%	92%	8.4
Norway	5.8%	98%	5.7
Italy	6.8%	64%	4.4
France	5.1%	76%	3.9
Hungary	2.3%	87%	2.0
Luxembourg	1.7%	99%	1.7
United Kingdom	1.7%	100%	1.7
Netherlands	1.5%	100%	1.5
Poland	6.5%	22%	1.4
Portugal	2.1%	48%	1.0
Czech Republic	5.7%	7%	0.4
Greece	0.3%	54%	0.2
Ireland	0.7%	0%	0.0

5. For the four federal EU member states only, the share of federal regions in total tax revenues for these EU-4 is 21.7% (2008, weighted average).

6. Author's own calculations based on: Hansjörg Blöchliger and Josette Rabesona, *The fiscal autonomy of sub-central governments: an update* (Paris: OECD, 2009).

Let us now turn to *spending power*. Just as with taxing power, spending power can roughly be measured by looking at the share of LRGs in total government spending. Across OECD countries this share equals 33%, across EU member states approximately 31%. Table 3 lists spending shares for most EU member states.

Table 3 Expenditure of LRGs in some EU member states as a% of total government expenditure (average 1995-2005)⁷

<i>Country</i>	<i>Unitary/federal</i>	<i>Spending share of LRGs</i>
Denmark	Unitary	57%
Spain	Federal	45%
Germany	Federal	43%
Sweden	Unitary	42%
Belgium	Federal	40%
Finland	Unitary	37%
Czech Republic	Unitary	36%
Ireland	Unitary	36%
Austria	Federal	35%
Netherlands	Unitary	35%
Poland	Unitary	30%
Italy	Unitary	29%
United Kingdom	Unitary	27%
Hungary	Unitary	26%
France	Unitary	18%
Slovak Republic	Unitary	17%
Luxembourg	Unitary	15%
Portugal	Unitary	14%
Greece	Unitary	5%

However, as with sub-central taxing, spending by LRGs may be heavily influenced by central level government regulation, reducing LRGs discretion over various budget items. Spending autonomy has various facets, of which policy autonomy and budget autonomy are most relevant in the context of this article.

7. Author's own estimates based on: Steffen Bach, Hansjörg Blöchliger and Dominik Wallau, *The spending power of sub-central governments: a pilot study* (Paris: OECD, 2009).

Policy autonomy refers to the extent to which LRGs can exert control over main policy objectives and main aspects of service delivery. Budget autonomy is the extent to which LRGs exert control over the budget and is limited by earmarking of intergovernmental grants and by expenditure limits.⁸ In practice, spending autonomy varies considerably across countries and across policy areas, making it impossible to draw a single conclusion on spending power for all LRGs in Europe, other than the obvious one that LRGs in federal states generally have relatively high spending power.

As far as the spending power of the EU is concerned, it is restricted considerably by an expenditure limit. Within the system of multi-annual financial frameworks (recently codified by means of the Lisbon Treaty and previously called the Financial Perspectives) expenditure is set for a 7-year period and capped by means of a 'resources ceiling'. This ceiling is decided upon unanimously by all member states, followed by ratification at the domestic level. Currently the ceiling is set in such a way that total EU revenues (made up of the EU's own resources and the GNI-based transfers that top up these own resources) should not exceed 1.24% EU-GNI. Because the EU is not allowed to run fiscal deficits, this resources ceiling is also the ceiling for EU expenditures. Moreover, the multi-annual financial frameworks set limits on specific expenditure categories within overall EU expenditure.

If we combine tax shares and expenditure shares, it is obvious that the whole European fiscal system is vertically imbalanced. Large vertical fiscal gaps exist, with central governments having excess tax revenue compared to their expenditure levels, and the EU and LRGs having too little own tax revenues to adequately pay for their expenditure. These vertical gaps are filled through upward funding (i.e. from the member states to the EU) and downward funding (i.e. from central governments to LRGs). In the case of the EU, the funding is done by means of a GNI-based transfer which accounts for approximately 75% of EU resources. Within member states various downward intergovernmental transfer systems are in place.⁹

This vertically imbalanced system, with central governments as omnipresent paymasters, is at odds with the developments, mentioned in the introduction, by which central governments have become less important in most policy arenas. Before turning to some federalism theories that could shed light on this situation, the question arises what possible impact this vertical imbalance could have on democratic legitimacy.

8. Cf. Bach, Blöchliger and Wallau, *op. cit.*

9. Of course, such systems also include elements that deal with horizontal equalisation. In this article these horizontal aspects are not dealt with.

Fiscal sovereignty and democratic legitimacy of the EU

Fiscal sovereignty is at the heart of the state and it always has been. According to the Roman philosopher, statesman, lawyer and political theorist Cicero, revenues are the sinews of the state.¹⁰ According to the Irish philosopher and politician Edmund Burke, in his observations on the French Revolution, the revenue of the state *is* the state.¹¹ In that sense it is understandable that central governments are reluctant to transfer fiscal powers to other levels of government. From the same perspective however, it can be argued that a state-like entity like the EU cannot do without proper fiscal powers.¹² A recent analysis of the statehood of the EU shows that the EU scores high on most criteria for being a state, except for the capacity to extract revenues from its subject population.¹³

One could argue that from the perspective of legitimacy, this is not necessarily problematic, if we do not see the EU as an imperfect nation-state but rather as a regional state, encompassing its member states, with shared sovereignty and a fragmented democracy.¹⁴ Input legitimacy is mainly to be taken care of at the national and sub-national level, the EU is primarily concerned with output legitimacy. From that angle, as long as the EU ‘delivers’, it can be deemed irrelevant whether it is financed by its own EU taxes or by member states’ grants. The snag in this is that the level of revenues of the EU and the levels of its main spending categories (and thereby its spending capacity) are set by the member states, who always have been (and lately seem to be more and more) worried with their own net positions and a *juste retour* than with the fiscal capacities of the EU. Although policy output in the EU is not only dependent on fiscal capacity, as regulatory capacity (which the EU generally is not lacking) is important as well, the current fiscal set-up seems to be a constant underlying threat to the – widely shared – ambitions of the EU (i.e. EU2020) and thereby to its output legitimacy. A simple comparison of the taxing power of the US federal government (18% US-GDP) with the EU (1% EU-GDP) shows how badly the EU has come off.

Input legitimacy on the EU level in fiscal matters is low. We have a ‘representation without taxation’, i.e. a directly elected EP that cannot fully represent EU citizens because decisions on EU revenues (the ‘own resources decision’) are taken by member states, with ratification on the domestic level, often meaning

10. Marcus Tullius Cicero, *Pro lege manilia*: 17, 66 BC.

11. Edmund Burke, *Reflections on the Revolution in France*, 1790.

12. In this section the focus is on the EU but all arguments are *-mutatis mutandis-* relevant to the position of LRGs as well.

13. Søren Dosenrode, *Assessing the European Union's Statehood*, paper presented at the MEIA research meeting in Aalborg, Aalborg University, March 9, 2011.

14. Cf. Vivien Schmidt, “The European Union: Democratic Legitimacy in a Regional State,” *Journal of Common Market Studies* 42/5 (2004).

involvement of national parliaments rather than EP.¹⁵ For obvious reasons, EP has used all its competencies to be part in the adoption of previous Financial Perspectives and it is heavily involved in the debate on the multi-annual financial framework for 2014-2020. But EP cannot properly represent EU citizens in their capacity as taxpayers whose taxes (eventually) end up in Brussels. It can be doubted whether this input legitimacy in fiscal matters concerning the EU is adequately taken care of on the national level (as the EU-as-regional-state-with-fragmented-democracy-idea requires). If not, the EU – as a level of government – has a double legitimacy problem: threats to its output legitimacy due to lack of resources and weak democratic representation (low input legitimacy). For the EU as a whole (i.e. as a regional state) the double legitimacy trap is looming¹⁶: insufficient output legitimacy at the EU level which cannot be compensated for by member states (because their problem-solving capacity has decreased within the internal market and monetary union, due to globalisation) and insufficient input legitimacy regarding EU affairs at the EU and domestic level combined.

What do we know about EU citizens' opinions in fiscal matters and the EU? The current standard-Eurobarometer contains a question on the decision-making power regarding taxation. Asked whether decisions on taxation should be made by national governments or made jointly within the European Union, approximately 70% of EU citizens favour national decision-making.¹⁷ Obviously this question is formulated too broadly ('decisions on taxation') to merit sensible conclusions. Another more relevant question from the most recent Eurobarometer dealt with citizenship and taxation. Asked for elements which would best strengthen their feeling about being a European citizen, only 12% of the respondents indicated that such an element would be a EP that had the right to decide on taxes raised in the EU.¹⁸ Unfortunately, again the question leaves too much room for interpretation ('taxes raised in the EU' rather than 'EU taxes raised in order to finance EU policies'). Earlier Eurobarometers (from 2003) specifically addressed the issue of EU taxes and the transfer system. Asked whether they preferred the system by which each member state transfers part of its tax revenue to the EU to a situation in which citizens transferred their contributions to the EU directly, a small majority of respondents indicated that they preferred member states' contributions to direct EU taxation (the latter option being preferred by only 20% of the respondents and with 30% of the respondents being

15. This system may make sense as far as the GNI-based transfers are concerned, but certainly not for the traditional own resources.

16. Cf. Tanja Börzel, *What can Federalism teach us about the EU? The German Experience*, paper (London: The Federal Trust, 2003).

17. Question 22.2, *Eurobarometer 73*, Spring wave, published in November 2010 (fieldwork done in May 2010). This result is pretty stable over the last years.

18. Question E3, *Eurobarometer 73*, op cit..

indifferent or unresponsive).¹⁹ It can be concluded that most EU citizens do not equate the EU with a fiscally sovereign entity.

Fiscal federalism theory and the EU

In Europe, there has always been a keen interest from economists in the application of *fiscal federalism theory* to the EU. Fiscal federalism theory, originating from the United States of America (hereafter: USA), deals with the issue of allocating taxing and spending power to different levels of government, from the perspective of different fiscal functions that governments have to fulfil. Often, the term fiscal federalism is wrongfully associated with a theory of fiscal *decentralization* within *federal* states only. The theory however deals with all systems that are federal in the sense that they encompass different levels of government which have *de facto* decision-making authority. Interestingly, even though (or maybe a result of the fact that) the USA has a constitution in which the federal set-up is laid down, federalism theories from the USA have always focused on such *de facto* competencies rather than getting engaged in discussions on statehood or federalness.

Building on the seminal work of Tiebout, Musgrave and Oates from the '60s and '70s of the previous century, the theory of fiscal federalism makes use of Musgrave's three basic fiscal functions: allocation, (re)distribution and stabilization.²⁰ The starting point of fiscal federalism theory is that these fiscal functions should play an important part in choices concerning the fiscal structure of government. Fiscal federalism theory is however not a comprehensive body of knowledge. It never has been. According to Musgrave: "[...] *there is no distinct theory of fiscal federalism. Rather, we deal with a composite of models, pointed at various facets of the problem*".²¹ These models share some basic ideas, or 'principles of fiscal federalism', which are discussed in almost every textbook on public finance (often immediately followed by a discussion of the economics of intergovernmental transfers). If one reconstructs fiscal federalism theory, one finds that its principles are actually rather heterogeneous and often lead to contradictory outcomes.²²

19. See for instance question 11.7.a, *Eurobarometer 59*, published in July 2003 (fieldwork done in March-April 2003).

20. By allocation we mean the allocation of different factors of production (labour, capital) to the production of different goods/services. Put in other words, the allocation of society's scarce resources between alternative (private as well as public) uses, in the most efficient way. By (re)distribution we mean the (re)distribution among citizens of the different (public and private) goods/services that are available in a society (or the income to obtain them). By stabilization we mean the stabilization of the economic process, in terms of growth, inflation, employment et cetera.

21. Richard Musgrave, "Theories of fiscal federalism," *Public Finance* 24 (1969), 521.

22. See in – far – more detail Nico Groenendijk, "Multi-level Governance, Network Governance, and Fiscal Federalism Theory", in: *Governing networks* (EGPA Yearbook 2001), ed. Ari Salminen (Amsterdam: IIAS/IOS Press, 2003), 349-370.

From the perspective of allocation, fiscal federalism theory prescribes tasks to be put on the lowest level possible, in order to fine-tune the supply of policies and services to citizens' demands. Uniform supply of policies and services to heterogeneous groups of consumers will result in welfare losses for all jurisdictions involved. The problem here is that different policies and services have different scales on which they operate, but that having a multitude of single-purpose governments with their own institutions, is not efficient on an aggregate level. Multipurpose governments however induce externalities as congruence between the scale on which decisions are made and the scale on which policies operate is not guaranteed. Such externalities result in under- or over-supply of policies and public services and can give rise to horizontal compensatory arrangements or intervention by higher-level governments. As far as the (re)distribution function is concerned, lower-level (re)distributional policy is not effective in case of mobility of labour and/or capital. If lower-level governments tax the rich and the rich will leave, this renders their redistribution policies useless. Again, some centralization of fiscal capacities is called for, but centralisation can lead to welfare losses in case of heterogeneity of preferences on (re)distribution. Something similar goes for stabilization. In open economies lower-level stabilization policies are not effective if they are not properly coordinated (or centralized), but such coordination or centralization could again be at odds with heterogeneous preferences of lower-level jurisdictions. Applying fiscal federalism theory thus is a balancing act between preventing welfare losses due to centralization under heterogeneity on the one hand and having efficient and effective policies and institutions on the other hand.

Unfortunately, fiscal federalism theory suffers from serious shortcomings which constitute impediments to its applicability.²³ Fiscal federalism theory assumes that a benevolent ruler is in charge of the balancing act, whereas in practice federal finances are decided upon in political power arenas in which actors operate that may have other interests on their mind than efficiency. Moreover, fiscal federalism theory does not sufficiently take into account path-dependence and assumes clean-slate decisions.²⁴ But most importantly in the context of this article, the theory assumes that tasks can usefully be separated and allocated to different levels of government. In that sense it corresponds mostly to the approach of dual federalism rather than to cooperative federalism, to which we now turn.

23. See Groenendijk, op. cit. for a more detailed discussion of these shortcomings. See also Jürgen von Hagen and Jean Pisani-Ferry, *Why is Europe different from what economists would like?*, paper prepared for the AFSE conference, Paris, 2002.

24. To be fair on the theory, this shortcoming is reduced considerably in the so-called second generation theory of fiscal federalism.

Dual federalism and cooperative federalism

Although in the European political arena, the F-word is most often gracefully circumvented, the concept of federalism has always been at the heart of the political debate in the USA. In this debate two models have been put forward, dual federalism and cooperative federalism. Dual federalism (sometimes referred to as the layer-cake model of federalism) is based on the idea that the federal government and state governments each operate and are sovereign in their separate spheres (*séparation des pouvoirs*). Policy functions do not overlap and governments are financially autonomous. In cooperative federalism (sometimes referred to as the marble-cake model of federalism) powers and policy assignments are shared between states and the federal government (*distribution des pouvoirs*). Federal government and state governments are mutually dependent with an overlap of functions and of financial resources. It is to this model that the US has moved since the New Deal era of the 1930s, as joint federal and state policies were developed to fight the causes and consequences of the Great Depression, although the introduction over the last decades of new exclusive powers to the US federal executive branch by some are seen as a partial return to dual federalism.

Over the last decades, the academic debate in the EU has picked up on – comparative – federalism, linking it to the multi-level governance literature.²⁵ Although some competencies are exclusive competencies of the EU, and although competencies that are not assigned are by default exclusive to member states, in most policy fields competencies are now shared between the EU and member states. Most authors agree that the EU resembles a cooperative federation more than a dual one, even though some dual features are clearly present.²⁶ This ambiguity has adequately been phrased by Börzel and Hosli as “*Brussels between Bern and Berlin*”.²⁷

‘Bern’ (i.e. the Swiss model) denotes the possible move of the EU towards a primarily dual system in which the EU (‘Brussels’) would have considerable competencies, including its own power to tax, but the same would still be true for nation-states. Nation-states would still be involved in EU decision-making but through weak representation (e.g. through a directly elected Senate as a second chamber to EP). Systems competition between nation-states is considered not to

25. See David Benson and Andrew Jordan, “Understanding task allocation in the European Union: exploring the value of federal theory,” *Journal of European Public Policy* 15/1 (2008) and David Benson and Andrew Jordan, “Exploring the Tool-kit of European Integration Theory: What Role for Cooperative Federalism?,” *Journal of European Integration* 33/1 (2011) for an overview of this ‘turn’ in EU studies.

26. Cf. (among others) Robert Schulze, *From Dual to Cooperative Federalism. The changing structure of European Law* (Oxford: OUP, 2009).

27. Tanja Börzel and Madeleine Hosli, *Brussels between Berlin and Bern: Comparative Federalism meets the European Union*, Working Paper no. 02/2002, Department of Political Science, Free University of Amsterdam, 2002.

be problematic as it may increase policy efficiency by reducing government failure.²⁸ This avenue is however a dead end for various reasons. First, as was true for fiscal federalism theory, such demarcation of competencies is at odds with practice in which competencies are increasingly shared. Secondly, additional transfer of competencies to the EU by member states combined with weak representation of these member states is not politically feasible. Thirdly, giving autonomous and separate fiscal powers to the EU would require new taxes to be developed as EU taxes. The problem here is that it is very hard to find suitable tax bases that are not already used by nation-states. Fourthly, it is questionable whether systems competition indeed increases efficiency in the public sector (as competition is assumed to increase efficiency in the public sector). Moreover, (re)distribution and stabilization issues have to be taken into account as well, and systems competition can have serious negative effects on cohesion, solidarity and economic stability in the EU.

'Berlin' denotes the cooperative federalism approach to the EU, in line with the German experience. In this model, taxing and spending powers are shared. The EU would acquire co-competencies of stabilization and redistribution. The European Commission would be the executive branch of government, with EP and the Council being co-legislators. To a large extent this is the model that we currently have, apart from the increased taxing and spending competencies of the EU.

Towards tax sharing in Europe

The question then arises how the fiscal competencies of the EU can be enhanced. Given the pivotal role of nation-states in fiscal matters and their reluctance to transfer fiscal competencies to the EU level or to LRGs²⁹, any change has to be minimal in order to be politically feasible. Tax sharing could be such a limited change in which nation-states keep their position as veto-players.

Tax sharing as a possibility to enhance the taxing power of the EU and/or LRGs is often dismissed on the basis that there is hardly any difference between tax sharing and upward/downward funding through intergovernmental grants. There are however well-defined differences between tax sharing and grants. Tax

28. See David McKay, "Policy Legitimacy and Institutional Design: Comparative Lessons for the European Union," *Journal of Common Market Studies* 38/1 (2000). The Swiss example has earlier been put forward as a model for the EU, in the form of functional (single-purpose), overlapping, competitive jurisdictions by Bruno Frey and Reiner Eichenberger, "FOCJ: Competitive Governments for Europe," *International review of Law and Economics* 16 (1996).

29. Unfortunately, in the literature on federalism the position of LRGs is often neglected, in spite of the increasing importance of regions in Europe, partly due to the European Commission that increasingly by-passes the nation-state in policy implementation.

sharing involves three combined elements, some of which are missing in the case of intergovernmental grants:³⁰

- Risk sharing: Is the amount of revenue allocated to the various levels of government strictly related to total tax revenue (e.g. as a given share of annual tax revenue), i.e. do all involved levels of government fully bear the risk of tax revenue slack and fluctuations?
- Un-conditionality: Are governments free to use the revenue allocated, i.e. are the revenues unconditional (non-earmarked)?
- Formula stability: Is the revenue share between the various levels of government predetermined in advance and not changed in the course of a fiscal year?

Within the EU all federal states (Austria, Belgium, Germany, Spain) use tax sharing arrangements as do some unitary states (Czech Republic, Denmark, Finland, France, Hungary, Italy, Poland, Portugal). Other unitary states do not have tax sharing arrangements (e.g. Greece, Ireland, Luxembourg, Netherlands, United Kingdom, Sweden).

It may seem odd that the discretionary power of different levels of government to autonomously set tax bases and rates within the tax sharing arrangements is not included above. However, such discretionary power would be counterproductive in the case of tax sharing as this would distort formula stability. Of course, it does make a difference whether tax bases and rates are set by one government only or through mutual consent by all governments involved. In most of the unitary EU countries that use tax sharing arrangements and in Austria, central government sets tax bases and rates. Such tax sharing could be labelled (centrally) *split taxation*. In three federal countries (Belgium, Germany, Spain) and in Italy there is co-decision between the involved governments. This type of tax sharing could be labelled *joint taxation*. Obviously, joint taxation fits the cooperative federalist model much better than unilaterally split taxation.

Joint taxation in the EU first requires taxes that are suited to be shared, in terms of magnitude, level of harmonization of the tax base and relevance to EU policies. In the most recent proposals made by the European Commission as part

30. Hansjörg Blöchliger and Oliver Petzold, *Finding the dividing line between tax sharing and grants: a statistical investigation*, OECD Network on Fiscal Relations Across Levels of Government, Working paper 2009 (10) (Paris: OECD, 2009). These are the three elements that deal with the vertical relationship between governments. Blöchliger and Petzold also discuss proportionality (i.e. the absence of horizontal equalization) which is not discussed here.

of the budget review, based on various criteria, three feasible options are put forward that involve tax sharing:³¹

- An EU share (based on a rate of 1%) in the VAT, which tax base is already fully harmonised.
- An EU tax on energy, the base of which member states can share to implement their own energy tax, with a joint harmonized tax base.
- An EU corporate income tax, to be combined with national corporate income taxes, with a joint harmonized tax base.

Secondly, joint taxation requires an institutional procedure in which all relevant government levels are involved. The current own resources decision already provides such a procedure, but should be changed in such a way that the European Commission and EP are involved at an earlier stage (rather than the current ex-post Inter-institutional Agreement). Furthermore, this procedure should be fine-tuned to involve LRGs in those countries that use tax-sharing arrangements on the domestic level as well.

Conclusion

The current vertical fiscal imbalance in Europe, with nation-states having the lion's share of taxing power and considerable upward and downward funding schemes, needs to be tackled, as this imbalance poses serious threats to the output and input legitimacy of the EU and LRGs in Europe. Rather than flatly dismissing the European Commission's proposals for fiscal reform, member states should search for solutions which do justice to their own interests, to the requirements for jointly conducting policies in the 21st century and to the EU's huge ambitions. Joint taxation is an option that has proved to be fruitful in federations everywhere in combining efficiency aspects and issues of (re)distribution and stabilization. It would seriously mitigate the current legitimacy problems and traps that the EU as a whole faces. Finally, but not unimportantly in the current times of domestic budget decline, with joint taxation all involved levels of government share the risk of tax revenue fluctuations, which is now born solely by member states.

Abstract

In this article data on fiscal autonomy of different levels of government in the European Union are presented. Within Europe central governments still hold the lion's share of the power to tax and spend. Other levels of government largely have to make do with upward and downward funding schemes which seriously diminish their fiscal autonomy. It is argued that this (vertical) fiscal imbalance has considerable negative impacts on especially the legitimacy of the European Union, both in terms of input and output

31. European Commission, *The EU Budget Review*, COM (2010)700 final-provisional (Strasbourg: European Commission, 2010).

legitimacy, and that the EU as a whole suffers from a joint legitimacy problem in fiscal matters. After a review of several theories on federalism (fiscal federalism theory, dual or competitive federalism and cooperative federalism) it is concluded that the model of cooperative federalism best suits the European Union. Part of this model is tax sharing (or joint taxation) which is advocated as a way-out of the current fiscal deadlock.

Résumé

Dans cet article sont présentées des informations concernant l'autonomie fiscale des différents niveaux de gouvernement dans l'Union européenne. Au sein de l'Europe, les gouvernements centraux se taillent encore la part du lion dans la répartition des compétences de taxation et de dépenses. Les autres niveaux de gouvernement doivent s'accommoder largement de plans de financement venus du haut ou du bas, ce qui diminue sérieusement leur autonomie fiscale. L'argument proposé dans cet article est que ce déséquilibre fiscal (vertical) a de considérables conséquences négatives, en particulier sur la légitimité de l'Union européenne, à la fois en termes d'input et d'output de légitimité, et que l'Union européenne en tant que telle souffre d'un problème de légitimité conjointe en matière fiscale. Après une étude des diverses théories du fédéralisme (théorie du fédéralisme fiscal, fédéralisme compétitif et fédéralisme coopératif), la conclusion est que le modèle du fédéralisme coopératif répond le mieux au fonctionnement de l'Union européenne. Une partie de ce modèle est la répartition fiscale (ou taxation conjointe), que l'on peut présenter comme une solution à l'actuelle impasse financière.