U.S. Intergovernmental Transfers: A Model for the European Union?

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Introduction

Leading Fiscal Federalism scholar Wallace Oates defined the discipline as "understanding which functions and instruments are best centralized and which are best placed in the sphere of decentralized levels of government". The United States is the oldest and certainly the most accomplished modern federation and is therefore regarded as the ultimate example to provide younger federations with guidance towards success. Nonetheless, the U.S. system has reached so high a level of complexity that it is immensely difficult to make sense of it in a simple description. On the other hand, the European Union is a more recent but no less complicated "federation-like" union, which bears at least one major resemblance to the United States insofar as it is considered being an ambitious, bold, and entirely new experiment in democracy.

The complexity of U.S. fiscal arrangements and intergovernmental relations is the result of over two hundred years of history, throughout which the share of competence has evolved according to economic, political and social circumstances. The kind of arrangements described in the Constitution drafted in Philadelphia in 1787 featured a decentralized form of government with a delegation of specific powers to the federal government. Yet, the American fundamental document was vague in many regards, which explains that its interpretation often led to political and legal conflicts. It must be said nonetheless that the American legal system is so designed that political arguments are settled \textit{a posteriori}, which allows for considerable experimentation on the part of the different levels of government. As a consequence, American intergovernmental relations are no longer what they were two hundred years ago. For the young European Union, there is certainly a lot to learn from the different stages and U.S. experiments in fiscal federalism. This was the inspiration guiding my work.

The comparative literature on the subject is rather large, yet I was surprised to discover how little has been published on the specific subject I decided to analyze: intergovernmental transfers. In my mind, intergovernmental transfers are the telltale signs of the nature of intergovernmental relations, for they allow to quantify government provision of public goods and to highlight the balance of power for the provision of those goods. I see one major reason why intergovernmental transfers would not be studied comparatively in the U.S. and the European Union: the incredible difference of scale between European and U.S. transfers.

I do not think that differences of scale prevent from conducting a comparative analysis of the two systems because what matters is first and foremost to come to grips with the nature of those transfers, and understand what they reveal about each system. However, it must be conceded that if the ultimate goal is to find what is transposable from the U.S. intergovernmental transfer system to the European’s, differences must be identified in the clearest way in order to determine the good practices that should be imported.


\textit{2} Referring to the United States, "intergovernmental" implies the relation between the different levels of government. For the European Union, the word usually describes the relation between the different Member States in its representative institution: the Council of European Ministers; yet, the word is also used sometimes to describe the relation between the different European Institution (the Commission, The Council and the European Parliament).
What exactly then can the European Union learn from the U.S. intergovernmental grant system, in the light of the significant differences existing between the two systems?

In a recent OECD pilot study, Steffen Bach et al. highlighted an interesting point in assessing the difficulties of the task I sat before myself. The study in question emphasized the shortcomings of analyses relying only on revenue and expenditure powers to determine the reality of intergovernmental relations between central and sub-central governments; therefore the OECD advocates for the definition of spending power indicators including criteria such as institutional, regulatory, and administrative controls, in order to more accurately paint the picture of intergovernmental relations\(^3\).

Although I did not have the OECD’s amount of data, I realized that studying the relevant features of the United States and the European Union’s intergovernmental transfers necessitated a thorough analysis of historical and institutional factors. Indeed, quantitative data does not bear enough explanatory value to arrive at significant conclusions as for what aspects of the U.S. grant-in-aid system are really applicable and should be applied.

That is why I designed this paper in a methodic way. Chapter One deals with the United States according to the following pattern: section A deals with the historical and political factors determining intergovernmental relations, then section B goes more deeply into the specific institutional aspects, and finally section C provides an in-depth quantitative analysis of the nature of intergovernmental transfers. Chapter Two reproduces a similar pattern although the focus is directly placed closer to the issue of the European’s ‘power of the purse’. A summary of the major findings of this work can be found under sub-sections “concluding remarks”.

This paper argues that despite the considerable differences existing between the United States and the European Union, it is possible to borrow certain U.S. mechanisms in order to attain the goals specific to the European Union. These mechanisms are (1) an actual European ‘own resource’ system, which would not have to be a direct tax with a broad base (such as the European income tax), but would allow a direct link to European citizens, turning them into European taxpayers; (2) The earmarking of certain European spending programs in order to carry out specific Community goals, while maintaining the current design of European subsidies to Member States since it allows real efficiency and intergovernmental cooperation\(^4\). The second major finding proposed can be linked to the first in that the main issue for the European Union is not necessarily to augment its resources, but rather to increase the efficiency of its spending programs. Yet, a direct link with the European citizens would provide the kind of accountability the European Union needs to involve its citizens further in the political project.

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\(^3\) OECD COM/CTPA/ECO/GOV/NP(2009)8, The Spending Power of Sub-central Governments : a Pilot Study

\(^4\) It will be shown that the current design of European subsidies to Member States is in fact very close to the U.S. grant-in-aid in many respects
Chapter one: The United States’ Fiscal Federalism:

“The question of the relation of the States to the federal government is the cardinal question of our constitutional system. At every turn of our national development, we have been brought face to face with it, and no definition either of statesmen or of judges has ever quieted or decided it.” (Wilson, 1961)

The first mistake one makes when observing American federalism from a European lens is to regard it as a constant and unwavering object, safeguarded by a Constitution immensely difficult to amend. The amendment procedure (Article V of the Constitution) is very stringent indeed, requiring the support of two-thirds of each house of Congress to introduce amendments, and three-fourths of the states to ratify them. Only then shall the Constitution be amended. It is easy to confirm the U.S federalism’s stillness, as there have only been twenty-seven amendments in over two centuries of existence, ten of which were drafted at the same time in 1791 as the “Bill of rights”.

This shows indeed the constancy and the reverence of the United States for their Constitution, yet it is a fact that the constraints imposed by it play an important part in maintaining the integrity of the fundamental document.

Although from a purely formal point of view it may be right to say that the United States has not evolved very much over the course of two centuries, a more practical point of view would suggest otherwise. The United States being a common law system, a very important share of institutional arrangements are determined by the courts, among which appears the highest jurisdiction that is the Supreme Court of the United States.

A- A historical review of U.S Federalism: towards more centralization

1. Establishing the Supreme Court’s power to settle Federalism disputes

The Supreme Court plays a significant role insofar as it possesses a very important power, which shapes federalism in the most definitive way: judicial review. The Supreme Court


I use the U.S Constitution provided by Cornell University Law School on its website:  http://www.law.cornell.edu/constitution/index.html
acquired this attribution with the decision rendered in the landmark case *Marbury vs. Madison*[^7], in 1803 under Chief Justice Marshall.

This case is perceived as the cornerstone of the American legal system in the sense that it founded the Supreme Court's power of judicial review, the ability to strike down statutes or pieces of law issued by the other branches of government.

*Marbury vs. Madison* was therefore an act of self-empowerment on the part of the Supreme Court, establishing it as a co-equal branch of government along with Congress and the Presidency. Ultimately, the Marshall Court affirmed its privilege of being at the top of the legal hierarchy, the final judge of the legality of a statute.

Henceforth, the role of the Supreme Court was very important in solving legal disputes and establishing constitutional standards, including what Woodrow Wilson envisioned as the eternal tug of war of the American federalist system, the relation between states and the federal government.

The *Marbury* case created the most important precedent in Supreme Court history, opening the first breach in the Constitutional wall that was built by the founders, and allowing the U.S federal system to evolve according to the interpretation of the law provided by the Union's highest jurisdiction, as new situations and conflicts arose.

With the historical insight we now have, it is fair to expand a little bit on Woodrow Wilson’s idea. Rather than the relation between the States and the federal government, the “cardinal question” of the U.S system is the relation between the federal government and sub-central governments, which includes states and local governments. These relationships are crucial factors in order to understand the nature of the U.S. federal system, often perceived as the oldest and most accomplished example of its type of government.

If we are to draw conclusions intended to help the European system benefit from the American experience of fiscal federalism, it is vitally important to understand how the system works and, above all, how it has evolved. I am not trying to underestimate the importance of theory here; I am simply willing to identify the real drivers behind a federalist process. What’s more, I would respond to the predictable objection that fiscal federalism differs from federalism by saying that in dealing with the ability of different levels of government to levy taxes, transfer revenue, spend taxpayer money in government programs, fiscal federalism is at the core of all disputes between the various layers composing a federal system.

Now why did I start off by clarifying the Supreme Court’s power to strike down laws and interpret the Constitution? Because all the standards of fiscal federalism have been established by the Supreme Court, though it was always in reaction to an attempt on the part of a government unit (either central or sub-central) to change the rules of the game. This is one of the major differences with the European Union, where institutional arrangements are so designed as to solve disputes over supranational spending at the political level, leaving almost no room for initiative at the European level.

As I shall demonstrate in the following section, the historical development of U.S. federalism owes much to the Supreme Court’s legitimacy in setting standards of constitutional interpretation as to the distribution of powers; among federal and state governments in particular.

[^7]: *Marbury vs. Madison* 5 U.S 137 (1803)

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Furthermore this section intends to show that U.S. federalism evolved through three different stages. The first stage is referred to as "dual federalism" and postulates a clear separation between national and sub-central government prerogatives. The second is usually called "cooperative federalism", by which scholars mean to qualify a practice in which central and sub-central governments share their respective attributions in order to bring about certain policy goals. The third and final stage is referred to as "creative federalism," a fairly misleading term. In fact, it is a euphemism meant to conceptualize a trend towards more centralization in the 20th century, reaching its climax in the 1960’s. In a document issued by the State Department and written by analyst Eugene Boyd (Boyd, 2006), “Creative federalism” is said to have lasted from 1960 to 1968. Although there is no reason not to rely on Boyd’s analysis, it does not convey the complexity of U.S federalism from the 1960’s onward.

2. The so-called “dual federalism” of nineteenth-century America

The debate over the powers granted by the Constitution to federal and state governments (local governments were not yet part of the debate since they were under state governments’ jurisdiction) has been a tug of war ever since the ratification of the U.S. Constitution in 1789, when the Federalist movement had seemingly triumphed. Article 1 section 8 of the Constitution laid out Congress’ enumerated powers, granting Congress the ability to provide only one public good –the postal service- within the States.

The other powers delegated to the Congress by the Constitution include the powers to mint currency (Monetary Policy), to levy taxes, to engage in international treaties and declare war, and to regulate interstate commerce (the Commerce Clause).

When the Bill of Rights was ratified in 1791, it included the Tenth Amendment, which stated that:

“The powers not delegated to the United States by the Constitution, nor prohibited by it to the states, are reserved to the states respectively, or to the people.”

This amendment brought about a clear separation between federal and state powers; this is the core of the “dual federalism” doctrine. Each branch of government acts within the realm of its sphere of authority as enunciated by the Constitution.

The doctrine of “dual federalism” is in practice a theoretical artifact insofar as the conflict over the nature of the union existed from the beginning, and many elements, both legal and legislative, shaped the balance of powers between states and the federal government in the early years.

First, there was the debate over the Congress’ establishment of Central Bank, created in 1791 but repealed in 1801 under anti-federalist president Thomas Jefferson. The issue finally made it all the way up to the Supreme Court in 1819 in the case McCulloch v. Maryland.

In this landmark case, Chief Justice Marshall settled crucial issues relating to federalism. Although he acknowledged that the national government was limited to the powers enumerated by the Constitution, he also affirmed that the Constitution vested “implied powers” in the Congress in order to achieve what is “necessary and proper” to carry out the powers and duties expressed in the Constitution. Therefore, the Marshall court upheld the creation of a Central Bank, legitimizing Congress’s ability to create a central bank.

as a necessary and proper way to achieve the enumerated powers of levying and collecting
taxes, issuing currency and borrowing funds.

The Marshall Court went on to affirm the supremacy (Supremacy Clause in Article 6
of the Constitution) of the national government affirming: “the constitution and the laws
made in pursuance thereof are supreme (...) they control the constitution and laws of the
respective states, and cannot be controlled by them.” By this he meant that the laws made
in application of the powers expressed and implied by the Constitution are at the top of the
U.S. legal hierarchy.

In 1824, the U.S. Supreme Court handed down another crucial decision about
federalism. In *Gibbons v. Ogden* 22 U.S. 1 (1824) the Marshall Court struck down a New
York state law offering one company the privilege to operate on the Hudson River, allowing
them to charge fees on out-of-state steamboats using the Hudson for commerce purposes.
The Supreme Court declared the New York statute invalid under the Supremacy Clause, for
Congress had passed a law regulating coast trade; moreover, the Marshall Court found that
regulating interstate waterways was a congressional prerogative by virtue of the Commerce
Clause of Article 1 Section 8 of the Constitution.

These two important cases illustrate the functioning of the so-called “dual federalism”
of the early nineteenth century, where the Supreme Court plays an essential part in shaping
the national government and the states’ respective realm of authority. It can generally
be affirmed that “dual federalism” has worked in favor of the federal government in the
nineteenth century, often in a conflicting context. *McCulloch v. Maryland* and *Gibbons v.
Ogden* illustrated two points that will be useful in a comparison with the European Union; the
first established Congress’ right to establish a Central Bank and recognized certain implied
powers, the second confirmed the federal government’s privilege to legislate over interstate
commerce.

This last trend was confirmed when Congress passed the Interstate Commerce
Commission Act (1887), and the Sherman Anti-Trust Act (1890), both based on the Court’s
Interstate Commerce doctrine and undoubtedly increasing the federal government’s power
over state legislation.

My reading of the early days of American federalism suggests that the framers, by
drafting Article 1 Section 8 and Article 6 in relatively broad terms, did not intend to draw
clear lines between federal and sub-central governments. This further renders the Marshall
Court’s interpretation of the “Supremacy Clause” (Article 6) and of the “necessary and proper
clause” so significant in that it ensured continuing changes in the distribution of regulatory
powers between national and sub-central governments.

The Supremacy Clause is all the more important as it provides Congress with a powerful
tool to enact laws invalidating the statutes of sub-central governments conflicting with federal
statutes. This way, Congress can legislate to remove sub-central governments’ regulatory
powers and expand the scope of its own power. Joseph F. Zimmerman calls this practice
Congressional preemption, and notes that there have been 522 preemption statutes from
1790 to 2004.

Despite the framers’ willingness to ensure change and adaptability in the distribution
of powers and duties among national and state levels, Edward S. Corwin has famously called

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9 *McCulloch vs. Maryland*, 17 U.S. 316 (1819)
nineteenth-century American federalism “dual federalism”\textsuperscript{11}. By “dual federalism”, Corwin meant what Chief Justice Taney expressed in a Supreme Court opinion in 1858\textsuperscript{12}:

“The powers of the General Government, and of the State, although both exist and are exercised within the same territorial limits, are yet separate and distinct sovereignties, acting separately and independently of each other, within their respective spheres”.

Even today, some legal scholars look at “dual federalism” with nostalgia; Justice Clarence Thomas, for instance, expressed the sentiment in two recent Supreme Court decisions in which a federalism issue was at stake (United States v. Lopez and Gonzalez v. Raich\textsuperscript{13}). Yet, it has been shown that “dual federalism” was mainly a theoretical artifact (Williams, 2007)\textsuperscript{14}; in reality, the Supreme Court has affirmed a jurisprudence recognizing certain overlapping competences between federal and state planes. Through its interpretation of interstate commerce, the Court defined the scope of this overlap as Williams rightly suggests. Nonetheless, the Court validated the principle of concurrent powers and duties it just drew a different land in the sand.

Joseph F. Zimmerman emphasizes this point of view through his groundbreaking federalism research\textsuperscript{15}, where he evidences that Congress started passing preemption statutes in 1790 with the Copyright Act and the Patent Act. Zimmerman insists that although Congress did not pass any other preemption statutes on concurrent powers until the enactment of the 1946 Atomic Energy Act, the national government and Supreme Court jurisprudence still did not forbid the expansion of national powers. Evidence of this phenomenon can be found with the creation of the ICC (Interstate Commerce Commission) in 1887, in order to regulate new technologies like railroads, the telegraph etc. But it is mostly to be found in the ratification of the Thirteenth, Fourteenth, Fifteenth, Sixteenth, and Seventeenth amendments, from 1865 to 1913.

Without going into much detail, I shall note that the Sixteenth Amendment allowed the creation of a federal income tax\textsuperscript{16}, while the Seventeenth Amendment established direct suffrage for the election of Senators. The former created the ability of the federal government to develop a grant-in-aid system, increasing states’ dependency, while the latter abolished an important safeguard for the states. Indeed, the Seventeenth Amendment widened a gap between the state and the federal plane, since the latter’s legitimacy was no longer controlled (in part) by state legislatures\textsuperscript{17}.


\textsuperscript{12} Ableman v. Booth, 62 U.S. (21 How.) 506, 516 (1858)

\textsuperscript{13} United States v. Lopez, 514 U.S. 549, 585-600 (1995) (Thomas, J., concurring); Gonzalez v. Raich, 545 U.S. 1, 58-59 (2006) (Thomas, J., dissenting)


\textsuperscript{16} The debate over the Federal Income Tax in the U.S. is interesting, since it was meant to be rather small, and designed to compensate the decrease in federal revenue caused by the reduction of tariffs. (Menéndez, 2004)

\textsuperscript{17} This turning point is often omitted when comparing the U.S. with the European Union; yet after the 17th amendment, the States no longer had one foot in the U.S. Congress. In the EU currently, Member States are represented at the Supranational level by an intergovernmental body composed of the executives of each Member States and their cabinet: the Council of European Ministers.
Interestingly, this new institutional arrangement gives more leeway to the federal government in preempting sub-central government regulatory competences, an organization that differs greatly from the European system. With the revenue generated by the federal income tax and legitimacy overreaching both the state and local government level, the federal government became directly accountable to the people who, in turn, expect their needs to be met.

The year 1913 represented a new era of American federalism, a year which would render intergovernmental relations more complex than ever, laced with more revenue transfers and overlapping competences.

3. From “cooperation” to “preemption”

As I have demonstrated, “dual federalism” never really existed in the law, for the Supreme Court never affirmed such a doctrine in practice (Williams, 2007) despite Chief Justice Taney’s rhetoric in 1858. Moreover, a strict definition of the state and federal governments’ respective realm of authority has been questioned by the Civil War amendments as well as by the 1913 decisive Sixteenth and Seventeenth Amendments.

Therefore, it would certainly be wise to expand the historical scope of cooperative federalism that is traditionally described as following “dual federalism," starting with F.D.Roosevelt's New Deal.

Cooperative federalism became the leading federalism theory after World War Two; it was made popular by the scholar Morton Grodzins and his marble cake metaphor – as opposed to the layer cake representing dual federalism.

The idea of cooperative federalism could be summarized as follows: The American system of government is built upon two foundations that are contradictory in appearance. The first is a very distinct separation between three branches of government and three different levels of government, each of which possesses its own prerogatives. The second foundation is a form of chaos, which forces the different levels of government to cooperate to solve certain issues that appear simultaneously in front of them. This latter foundation involves some concurrent powers and forces the different levels of government to share and work together to solve problems.

Typically, the Great Depression provides a good example in which issues arise at the state and central government level, calling for a response involving the different layers. Cooperative federalism is characterized by a high-level of bargaining between the different layers of government to determine how regulating powers will be shared and enforced.

Nonetheless, the 1960’s gave a bad name to cooperative federalism, which had turned into a “coercive federalism” where Washington D.C policymakers forced laws upon sub-central governments who were obliged to comply by being exposed to federal sanctions. Zimmerman has described at great length how the Johnson administration started passing preemption statutes to carry out its Great Society program, using conditional grants-in-aid as one tool among many to ensure full compliance on the part of the states.

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18 Quote p.9
Conditional grants-in-aid became more and more common in the first half of the twentieth century. In the majority of cases, states applying for a grant have to enforce a federal standard on a specific policy area, with little or no discretion. The amended Federal Road Aid Act of 1921 is the first major innovation in "coercive" federal grant programs. This act featured the first "single state agency" requirement, which meant that the state highway department had to administer the federal program. The novelty resided in an evaluation and control device by the federal Department of Agriculture that had the ability to withhold federal involvement if the grant was not properly administered.

The 1923 Supreme Court case Massachusetts v. Mellon confirmed Congress’ ability to use grants-in-aid to require states accepting the grant to use their reserved powers to implement a federal policy provision.

The amount of conditional grants-in-aid increased during the New Deal era, without raising too much controversy; the relative non-conflicting nature of grant-in-aid devices in this era has led scholars to call it cooperative federalism. As previously noted, the post-war era was somewhat more divisive as the federal government’s coercive handling of new areas of regulation led to many conflicts.

The theory of federalism could not cope with the pace of federal government activity and the theories of federalism often failed in grasping the real nature of intergovernmental relations from the 1960’s until today. As a leading federalism scholar observed in 1987: “the center-periphery model of statehood is challenged by the champions of a new model, which views the polity as a matrix of overlapping, interlocking units, powers and relationships. The efforts to come to grips intellectually with all these phenomena have been slower than the movement in the real world. The accepted intellectual models have tended to lag behind actual developments.”

4. Concluding Remarks:

The Evolution of American Federalism is marked by several important trends. First, it is founded by a Constitution that establishes independent powers to the federal government, leaving the rest to the States and the People (Tenth Amendment). (1) Early in its history the United States Supreme Court has asserted its power of judicial review and used it to settle federalism disputes among central and sub-central governments. The Courts jurisprudence established certain groundbreaking precedents that laid the groundwork to the extension of the Federal government’s few enumerated powers. (2) Some crucial amendments were made to the Constitution: the Civil war amendments in the 1860’s, and 16th and 17th amendment in the early twentieth century. These amendments extended considerably the scope of Federal power, especially the Sixteenth amendment that created the first broad-based Federal Tax, although the rationale was merely to replace the reduction on tariffs. The Seventeenth amendment on the other hand, abolished a significant barrier for the federal government’s emancipation by providing U.S. Senators with the legitimacy and accountability of direct suffrage. (3) The first half of the twentieth century pictured the increasing power of the Federal government; the New Deal era especially created more Federal programs (Social Security Act, 1935 notably), although less controversially than later in the 1960’s. (4) The post-war era saw the development of many federal programs in


22 Regarding this, it is very interesting to compare the powers acquired by the Federal government with the draft of the 14th amendment with the European “non-discrimination” principle. They both contribute to the extension of “federal” powers.
areas where the states had not legislated yet, or even preempting certain areas of regulation reserved to the states so far.

This era saw the development of many grants to state and local governments until the Reagan era. Now I have established the significant historical and institutional trends at play in the shaping of U.S. federalism, I will turn to a more specific analysis of U.S. fiscal federalism in the Contemporary era.

B- The Basic Structure of U.S. Fiscal Federalism

“The federal system was created with the intention of combining the different advantages which result from the magnitude and the littleness of nations” Alexis de Tocqueville (Chapter VIII, Volume I, Democracy in America)

As explained in the previous section, the United States government is a federalist system composed of overlapping structures of government including federal, state and local units. Unlike many other federalist systems, state and local governments play a large part in the implementation of public policy. Interestingly, this characteristic represents a common point shared with the European Union system though the logic behind this state of fact differs in many ways.

The U.S system comes from a tradition of participatory democracy and checks and balances as embodied by its fundamental document. The previous section explained certain aspects of this model of federalism, emphasizing the perpetual “tension” existing between the different levels of government. The European Union differs insofar as the supranational level was built upon already existing and highly developed national structures of government. I shall emphasize these differences in Chapter 2, but for the time being I shall turn to an in-depth discussion of the American fiscal federal system in order to paint a picture that will serve as the basis for a constructive comparison between the two systems.

The U.S government is composed of 50 states, and 89,476 local governments encompassing counties, municipalities, townships, school districts and special service districts. Local governments are divided into 39,044 general-purpose local governments and 50,432 special-purpose governments such as school districts. The clear demarcation between general-purpose local governments and limited-purpose local governments is fairly unusual in a federalist system. Although local governments depend legally on state governments, the division between special-purpose and limited-purpose structures permits more frequent interaction among the three major levels of government. In certain cases, the federal government can reach over the states directly to local governments for certain grants and projects.

1. The Structure of the U.S. government

The relationship between state and local governments varies immensely from state to state. In New Hampshire for instance, local governments are the relevant actor in terms of public expenditure (They represent more than half of the State’s revenue. See Table.1), whereas in Hawaii, they hardly play a major part (Local government revenue barely accounts for

23 U.S. Bureau of Census, 2007 census of governments
20% of sub-central government revenue). A similar discrepancy reveals itself when one examines the relationships among local governments. In Massachusetts, the key level is the municipality; however, in Maryland, counties are the most relevant scale of government.

Evidence shows that the U.S. federalist system bears little resemblance to the one envisioned by the framers, or that it at least reflects the essential ambiguity of the Constitution on the sharing of powers and duties among the different echelons of government. As I have previously explained, the federal government expanded its roles over two centuries of existence, mainly through initiatives ultimately validated by the Supreme Court. This resulted in major shifts in the balance between federal, state and local governments.

Overall, the share of government expenditures in the country’s GDP has increased, but the federal government and the states are the major source of funding. Conversely, local governments relative share of total government expenditure has decreased significantly over the course of the twentieth century. This trend accelerated in the 1960’s as the Johnson administration implemented its Great Society platform, expanding income transfers to the poor and the elderly. Similarly, state governments intensified their participation in areas that were the responsibility of local governments in the past.

As Table 1 shows, the share of state government in total sub-central government revenue has increased until the 1990’s, before stabilizing around 60% in 1997.

This evolution towards more de facto centralization (both at the state and federal level) led to larger amounts of intergovernmental grants from higher to lower levels of government, generally through categorical or special-purpose grants. The federal government did not spend directly the considerable funds it accumulated starting from the 1960’s; instead it transferred an important amount of resources to lower levels of government so that they retained administrative control over their traditional programs.

The same thing happened between state and local governments, with states handed over funds to local governments for education (school boards are usually part of local governments) or other purposes.

Overall, the share of intergovernmental grants in local government revenue increased up to 44.1% in 1980 before scaling back to 37% at the end of the Reagan era, and the number increased again under the following administrations stabilizing around 38.5%.

Intergovernmental grants grew most rapidly between the 1960’s up until the 1980’s, resulting from the strong fiscal position the federal government enjoyed vis-à-vis state and local governments. This vertical imbalance no longer existed after the weakening of the federal government’s budgetary position in the 1980’s. Now state and local governments have almost bridged the gap, and are questioning the efficiency of certain federal mandates.

Considering the federal government’s budgetary position in the 1960’s, it had been argued that important intergovernmental transfers would create a more efficient and more

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24 Categorical or special-purpose grants are transfers meant to be allocated to a category of spending or to a specific program. They are usually opposed to lump-sum grants, which are general-purpose grants aiming at closing the fiscal gap between states.


equitable system of government. The 1980’s led to cutbacks in federal aid programs and a movement on the part of the states to end some unfunded federal mandates.

The U.S. grant system is theoretically not aimed at achieving horizontal equalization since it has very few general-purpose grants; of the 618 grants that existed in 1995, only 15 were block grants. The U.S. grant system is actually based on categorical grants, and although some equalization criteria are included in their formula, their goal is mainly to enforce minimum standards.\(^{27}\)

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Table 1 - State Percentage of State and Local Tax Revenues, Selected Years 1977-2006

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27 Advisory Commission on Intergovernmental Relations, Characteristics of Federal Grant-in-Aid Programs to State and Local Governments- FY 1995, June 1995

DUFOULON Julian 17
2. How does U.S. Tax administration work?

The United States has a decentralized tax administration system giving a maximum independence to sub-central governments to control the base and rates of their taxes. Sub-central governments also have their own tax administration to collect taxes; yet this system results in inflated compliance costs for taxpayers and higher administrative expenses for government units.

The American people and businesses have to file both federal and state tax returns, starting with the former. The burden of filing the state tax return depends mostly on the degree of correspondence with federal income tax laws. There can be considerable horizontal overlapping when a citizen lives in one jurisdiction and earns income in another. To alleviate this overlapping, a jurisdiction will allow a credit for taxes paid to another.

Businesses operating in more than one jurisdiction have to apportion and allocate the interstate income among the states; the most common formula is a combination of equally weighted sales, property and payroll taxes. Nonetheless, the tax burden for businesses operating in more than one state can create something of a nightmare as some states double-weight sales taxes to use a two-factor formula, or sales-only to apportion income. The result can be highly inefficient because the same income can be taxed in several states in some circumstances, while certain income will avoid taxation at the state level altogether (see Table.3)\(^{28}\).

Considering the lack of efficiency characterizing this system, a strong case can be made in favor of a uniform apportionment formula for business income, or at least of the creation of an interstate board seeking to coordinate such calculations. It is important to note that the federal government has no jurisdiction over the enforcement of such uniformity; in fact, it rests at the states' discretion.

Moreover, the Advisory Board on Intergovernmental Relations (ACIR), an independent and bipartisan intergovernmental agency whose mission was: “To strengthen the American federal system and improve the ability of federal, state, and local governments to work together cooperatively, efficiently, and effectively” was officially disbanded in September 1996 after 33 years of existence.

Coordination of the U.S. tax system is now left to bargaining among individual states and with no federal agency lobbying in favor of more horizontal uniformity in the U.S. federalist system, the situation remains as such. The only existing mechanism allowing a certain degree of synchronization between the states and the federal government is the exchange.

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29 Archive of the ACIR website at: [http://www.library.unt.edu/gpo/acir/Default.html](http://www.library.unt.edu/gpo/acir/Default.html)
of information. This permits states to follow-up on individuals or businesses that file a federal tax return (always filed first) but not a state tax return.

Perhaps, the most interesting initiative on the part of the federal government in order to achieve better cooperation was the passing of the State and Local Fiscal Assistance Act and the Federal-State Tax Collection Act of 1972.\(^\text{30}\) The State and Local Assistance Act was presented in Congress as a mechanism breaking away from the usual kind of federal aid offered to states and local governments; in actuality, it was supposed to give sub-central governments more leeway to use federal aid, rather than them depending on categorical grants and their narrowly defined purposes. The system established by the bill would provide 30 billion dollars over a five-year period; the allocation formula designated about two-thirds for local governments and one-third for state governments, and was adapted to each state to accommodate individual needs and account for the balance of power between state and local governments. This aid was to be distributed on the condition that sub-central governments receiving it were subject to federal auditing and guidance; state and local governments would therefore have to follow federal guidance in setting up their tax rates in order to cover as many expenditures as possible with their own sources of revenue. This was in fact a revenue-sharing program designed to allow states to solve their budgetary problems at the time, it was not exactly a bailout but the states financial difficulties definitely motivated the bill. It was repealed in the 1980's. In fact, it could be argued that 1972 was the closest the U.S. had ever been to Centralization.

The principle attached to this bill was that the federal government would “help the states, as well the localities who help themselves”\(^\text{31}\). The Federal-State Tax Collection Act meant on the other hand a major federal intrusion in state affairs, and even an important pressure on a state’s constitutional right to establish and collect its own taxes. Nonetheless, the 1972 procedure was not made compulsory –the mechanism would have certainly been challenged in court otherwise! –no state therefore chose to participate in this federal program, which was ultimately repealed in 1990.

Among the many reasons why states refused to adopt the federal government’s “piggyback” arrangement included the obligation to align state income tax laws with federal income tax laws, the fact that some state revenues would have been subject to changes in the federal income tax base, and the loss of state jobs. In reality, this federal initiative was groundbreaking and would certainly have led to serious economies of scale in administrative management costs. The “piggybacking” system would also have brought additional revenue to many states in making it easier for taxpayers to file their tax forms. Lastly, the “piggybacking” system was created on the basis of congressional research showing that among the forty states having a general income tax at the time, twenty had already conformed to federal income tax laws while eight more were in the process of doing so.

The fact that no state elected the “piggybacking” system says much about state reluctance to consent to any limitation on the fundamental power of taxation. In this case, the efficiency argument holds little clout since states are more concerned with the vertical


balance of powers. It is also true that the “piggybacking” system would have resulted in the federal government preempting the income tax; combined with the degree of preemption contained in the 1972 State and Local Fiscal Assistance Act, 1972 assuredly represented a threat for state “sovereignty”\textsuperscript{32}.

3. Federal-State budgets: self-imposed constraints and implicit ‘no bailout’ clause

Typically, the fiscal year for state and local governments ends on June 30, with the exception of Alabama and its school districts, Michigan, the District of Columbia, Nebraska, Texas and New York. The federal government’s fiscal year runs from October 1 to September 30, decided by an act of Congress in 1976. Most state governments have balanced budget requirements prohibiting them to run budget deficits. It is important to note that there are no “hard budget constraints” imposed by the federal government on sub-central governments. The balanced budget requirement is most often a self-imposed stringency, validated by state constitutions. The only notable exception is that of Vermont, which does not have a balanced budget requirement.\textsuperscript{33}

The nature of balanced budget requirements can be characterized by one or all of the following four possibilities: (1) the governor presents a balanced current budget, (2) the legislature passes a balanced budget, (3) the governor signs a balanced budget, (4) or the state is prohibited from rolling a deficit over to the next fiscal year\textsuperscript{34}. States usually divide their budget into a current budget and a capital budget, allowing them to finance certain projects through borrowing and short-term debt. This gives some flexibility to states that are not willing to balance their budget immediately; but as Stotsky and Sunley point out, this prevents states from addressing their budgetary dilemmas immediately, which inclines them to run long-term deficits in subsequent years.\textsuperscript{35}

According to Mark Hallerberg\textsuperscript{36}, there are two ways in which a central government can impose restrictions on sub-central government deficits. The first is by establishing \textit{hard budget constraints}, restricting how much lower levels of government borrow, and the second is by using market pressure to discipline sub-central governments; the latter is a form of \textit{soft budget constraint}, though the author does not identify it as such.

In the United States’ case, the federal government is not entitled to impose \textit{hard budget constraints} and must therefore resort to tactics such as market pressure, or make sure that the states do not expect a federal bailout. Hallerberg cites the example of the city of Philadelphia in September 1990, when city officials decided to issue $375 million in bonds

\textsuperscript{32} I put sovereignty into brackets for states are not sovereign under the U.S. Constitution, which is why the U.S. changed from confederation of states to a federation in 1789.

\textsuperscript{33} The state and federal budget information was found in: \textit{Significant features of fiscal federalism: Budget processes and tax system, Vol.1.} Advisory Commission on Intergovernmental relations, 1995. Table 1,2,3


\textsuperscript{35} Ibid. P.63

to repay the public debt. Bonds are rated by specific agencies according to the market’s expectation on the state or local government’s ability to repay the debt. In Philadelphia, market expectation was so pessimistic that the bonds received a very poor rating, making it impossible for the city to finance its debt that way.

For the moment it is only necessary to point out that the arbitration between soft and hard budget constraints is mostly determined by whether sub-central governments have the ability to raise their own revenue or are financed mostly by government subsidies and grants. The European Union follows this theoretical pattern since it adopted hard budget constraints in 1997 in Amsterdam. The major difference with the U.S. is that European Nation-states have been used to utilizing fiscal policy and public deficit to finance government programs. Therefore Hallerberg finds that hard budget constraints will certainly not have a significant effect on the EU and may certainly be counterproductive. On the other hand, it would be mistaken to believe that there are no government deficit and no bailouts in the U.S. There are enough examples to prove the opposite; the last to date was the City of New York in the 1990’s.

4. Concluding remarks

As I have already said, there is little knowledge in France about the diversity of each and every U.S. state. Table 3 showed the variety in the revenue mix between states allowed by two independent levels of government with taxing powers. Despite the overlap that can be observed, I find that the greater variety in the Revenue mix is more likely to encourage tax competition especially for the mobile tax base (i.e. big businesses and high-income families). This part also aimed at showing the total absence of coordination between U.S. states and the failure of every federal attempt to achieve such coordination. It seems that U.S. states fear competition between one another way less than federal encroachment over their powers. Finally, section B aimed at showing that although there is no hard budget constraint coming from the top in U.S. fiscal federalism, such constraints exist but are self-imposed. The federal government possesses several means to make sure states abide by their self-imposed constraints. Those have not always been efficient.

C- The logic of U.S. intergovernmental relations

In the previous section, I have attempted to introduce basic characteristics of the U.S. federalist system. I would call these characteristics purely formal, having to do with the basic structure of the American system. This section takes the issue of U.S. fiscal federalism one step further, as I will analyze in greater detail how the system works in practice and the problems that affect it.

As it may have been noticed, my work so far has deliberately shied away from the wide theoretical literature on fiscal federalism. The reason for this is, as Barry R. Weingast said, “Much fiscal analysis of developing countries is on the following pattern: the academic literature is drawn on to construct a model fiscal system; the existing situation in a particular
country is examined to determine how it diverges from the model; and a fiscal reform is then proposed to transform what is into what ought to be.\(^{37}\)

In a comparative perspective, this rings all the more true in that what is to be determined is not how well each system studied fits a model, but rather how they respectively work in practice and what good practices can be drawn from each model. For a concise and sound discussion on the theory of fiscal federalism, I recommend Wallace Oates’ *Toward a Second-Generation Fiscal Federalism*.\(^{38}\) I will certainly use Oates’ synthetic work to position the issues raised by the economic theory on fiscal federalism, yet my main concern is to single out the most crucial aspects of the U.S. federalist system and what makes it unique.

It is important to remember that the economic theory on fiscal federalism is concerned with one thing - how to make institutional arrangements that will ensure the highest-level of public goods, what I shall call the “optimal equity goal”, while inducing the smallest possible costs, which I call the “optimal efficiency goal”. To some extent, the theory of fiscal federalism is a utilitarian theory in that it hopes to reach a Pareto-optimum. I retain the crucial explanatory value of the economic theory, while maintaining that federalism is determined by far more criteria than merely rational one, which is why my analysis is based on the actual functioning of the U.S. and European systems and their driving forces.

1. Tax expenditure

This section intends to study the current arrangements in intergovernmental relations. Traditionally, state and local governments have been responsible for the provision of the most basic public goods: highways, public welfare, universities, and public works at the state level, and elementary and secondary education, police and fire protection at the local level. The federal government traditionally takes care of public welfare, and national defense; but the practice is not fixed and this “tradition” has thus considerably evolved.

Graph 2 shows that in the past twenty years, the federal government’s main category of spending has been human resources including Social Security, Medicare, health expenditures and income security. Meanwhile, national defense expenditures have dropped since the Korean War, only increasing circumstantially when the U.S. engaged in major armed conflicts (the Vietnam War, the Gulf War, and the Second Gulf War). The federal government has become an important source of funding for public welfare and public works, although the provision of these services often remains in state hands.

As Table.4 shows, the share of intergovernmental grants in federal expenditures has increased almost constantly since 1977, from 3.8% to 10.3% of total federal outlays in 2006. At the same time, the share of federal government expenditure in total government expenditures has slightly decreased from 1977 to 2006 (66.4% of GDP on average while it represented 67.2% in 1977), while state and local spending represent 57.3% of total government expenditures on average over the period studied, when it accounted for 53.2%

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\(^{37}\) Barry R. Weingast, *Second Generation Fiscal Federalism: Implications for Decentralized Democratic governance and economic development*; a paper commissioned by ARD, Inc., under USAID Contract No. AEP-I-00-00-00016-00, TaskOrder No. 08, designed to inform the Agency’s “Decentralization and Democratic LocalGovernance Programming Handbook Revision”.

in 1977\textsuperscript{39}. This indicates that the states’ role has increased in the provision of public services in the last three decades, often through the enactment of federal programs.

A similar trend can be found by examining the expenditure relationship between state and local governments. States have increased their share in the funding of public education, while local governments retain control of the provision of such services. Overall, the past three decades have led to major expenditure overlapping among the three planes of government; yet the numbers tend to confirm a certain status quo on the share of competence over the provision of public goods.

\begin{table}[h]
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\begin{tabular}{|c|c|c|c|c|}
\hline
\textbf{Year} & \textbf{State} & \textbf{Local} & \textbf{Total} & \textbf{Direct}\textsuperscript{12} \\
\hline
1977 & 26.3 & 3.7 & 30.0 & 23.3 \\
1980 & 27.0 & 3.8 & 30.8 & 24.5 \\
1985 & 27.0 & 3.5 & 30.5 & 24.2 \\
1990 & 27.0 & 3.5 & 30.5 & 24.2 \\
1995 & 27.0 & 3.5 & 30.5 & 24.2 \\
2000 & 27.0 & 3.5 & 30.5 & 24.2 \\
2005 & 27.0 & 3.5 & 30.5 & 24.2 \\
\hline
\end{tabular}
\caption{State Government Expenditures, Selected Years (in Percent GDP)}
\end{table}

\textsuperscript{39} Note that adding the federal to the state and local expenditure average over the period studied does not equal 100%. For an explanation see footnote 2 under Table 4.
Table 5: Total Government Revenues, Selected Years (as percent of GDP)

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<th>Total Government Receipts</th>
<th>Federal Government Receipts</th>
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<th>Intergovernmental Source [%]</th>
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1. Excludes duplicative intergovernmental transactions; it is less than the sum of the state and local totals in columns 4 and 6.
2. Includes taxes, user charges, miscellaneous general revenue, utility revenue, liquor store revenue, and social insurance revenue. Own-source total revenue is calculated by subtracting intergovernmental revenue from total revenue. This figure should not be confused with own-source general revenue.
3. Includes substantial but unknown amount of federal grants to states that are "passed through" by the states to local governments.

In 2006, total government expenditures were 31.8% of gross domestic product; the federal government’s overall outlays were 20.4% of GDP, while states’ represented 11.9% and local governments 10.7% (Table 4). The numbers have changed over time, with state and local governments becoming more important participants since the 1960’s. Again, the numbers tend to convey the idea that the federal government carries less weight in the agglomerate of government expenditures than it had until the 1980’s. Another element confirms this fact: the assortment of expenditures at the federal level has seen intergovernmental aid decrease overall – although it has increased in absolute amounts. Therefore, states have received increasing amounts of money to implement part of the federal government’s public welfare programs, more specifically, its health and income security programs.

The reason why intergovernmental aid seems to weigh less in the mix of federal expenditures is that its progression is far less significant compared to that of Medicare and Social Security. One should bear in mind that the Medicare and Social Security programs are direct payments to individuals that do not require lower levels of government to provide...
them. The component of federal expenditure having significantly increased is interest on government debt (this sentence seems random and out of place).

2. Tax Revenue

As I have previously explained, the U.S. Constitution grants independent taxing powers to the states and the federal government; local governments’ taxes are established by state constitutions. The different levels of government do not share taxes, although most of them use the same revenue sources. There are no shared taxes or tax rates between states either.

In 2006, state government revenues were 13.7% of gross domestic product and those of local governments amounted to 10.8%. On the other hand, federal government receipts were 18.5% of GDP and total government receipts were 28.8%\(^40\) (Table 5.). The most important trend to note is the increase of state and local in the share of total government revenue since 1977; state and local governments’ revenues were 21% in 2006 while federal government receipts were 18.5%. In fact, state and local governments own sources (intergovernmental grants excluded) of revenue that accounted for 17.6% of GDP, thus remaining under the total of federal government revenue. Still, the revenue mix has changed dramatically since the end of the 1970’s and sub-central governments almost catch up with the federal government’s revenue.

Federal government revenue relies mostly on the personal income tax and payroll taxes (See social insurance and retirement receipts in Graph.1), which represents 80% of total federal revenue. There have been major changes in the federal revenue share since the introduction of the personal income tax in 1913, but the most significant shifts have taken place in the second half of the twentieth century with the drastic decrease of excise taxes and the corporate income tax (barely 10% of the total revenue share since Ronald Reagan’s first term – it was brought back to 15% by the George W. Bush administration in 2003) as major sources of revenue, indeed replaced by payroll taxes and the personal income tax. It is worth noting that there exists no broad-based consumption tax at the federal level in the United States, and although the 2009 Health Care Reform initiated by the Obama administration has given rise to ongoing debate about a federal value-added tax.

\(^{40}\) Once again, the sum of federal, state and local revenues is more than total government receipts because the latter excludes duplicative intergovernmental transactions.
At the state level, the composition of revenue differs widely, as Tables 3 and 7 show. States like Texas, for example, neither have a state income tax nor a corporate income tax; Texas relies mostly on the state sales tax for its revenue. If one only considers the aggregate data for state revenue, as shown in Table 7, it appears that states depend for the most part on individual income taxes and broad-based sales taxes as their major revenue source. Nonetheless, the revenue mix has changed drastically in recent years, for state income used to be based on selective sales taxes and the corporate income tax.

Table 7 - 2007 State Tax Collection by Source (Percentage of Total)

<table>
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<tr>
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-- tax not levied at state level.
* Selective sales taxes are state Excise taxes (i.e., motor fuel, alcoholic beverages, etc.)

Source: Federation of Tax Administrators
http://www.taxadmin.org/its/layer/07/taxdis.html

38 of the 50 states have a property tax, but their rates are very low, with the exception of those in Vermont and New Hampshire (Tables 3 and 7). These low rates can be attributed to the fact that local governments generally use property taxes as their main resource. Indeed,
these taxes represented 71.7% of total local government revenue in 2006. This number has decreased since 1977 (see Table 8) as the share of intergovernmental grants, both from the federal and state governments, has increased significantly.

The broad range of revenue mixes at the state level shows important differences in political culture specific to each state; it should be emphasized that there is no notable effort towards horizontal coordination or harmonization of state tax rates.

3. Intergovernmental grants: the three objectives of U.S. grants

I have already introduced the problem of intergovernmental transfers to illustrate the treatment of cooperative federalism in Section A. I emphasized the potentially inconsistent nature of the U.S. grant-in-aid system. This section attempts to qualify the purpose and the functioning of this system, which is for the most part based on categorical grants with low equalization criteria. Indeed, I will show that U.S. vertical transfers generally aim at establishing minimum standards although they may also, on certain occasions, lead to some degree of equalization with local governments rather than with state governments.

U.S. subsidiarity is slightly different from the European one; in fact, there is no such “principle” at play in the American federalist system, although one might argue that it exists to a small extent. In the United States the different planes of government usually have their respective set of competences for a specific area of public policy. But as I have shown in the previous section, there is considerable variety of combinations between states. Moreover, the U.S. has a very complex system of intergovernmental grants, which designs a complex web of transfers. From a subsidiarity perspective, it creates major overlapping in public spending, although it must be said that transfers do not usually change the part each level plays in providing public service.

More importantly, transfers determine who will elaborate and who will control the different public services; to this regard, the United States have leaned towards more centralization over time, concentrating most of the spending power in the hands of the states and federal government. This more centralized logic diverges from the premise of the theory of fiscal federalism as exposed by Charles Tiebout in his watershed article of 1956. Tiebout described a decentralized model of fiscal federalism that produced “local public goods”. The model showed that mobile households make individual choices according to their preferences in local public goods. According to Tiebout, these individual choices resulted in Pareto-efficient outcomes.

Wallace Oates summarizes the premise of fiscal federalism in the form of a dilemma. On one hand, the more uniform outputs coming from a centralized system result in inefficiencies by inadequately reflecting the divergences between localities. On the other hand, a decentralized system is more inclined to fail in dealing with interjurisdictional externalities. However, the amount of spillover effects helps determine whether centralization or decentralization is sufficient.

As I shall now demonstrate, the U.S. model of intergovernmental grants is evolving towards more centralization, progressively drifting away from Tiebout’s model (if it had ever been close to it). The logic behind this trend is an increase in the federal government’s attempt to establish minimum standards in most public policy areas. What’s more, the grant-in-aid system can be a powerful macroeconomic management tool.

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Indeed, the 2009 Recovery Act passed to deal with the economic downturn will represent about one-fifth of federal grants to state and local governments in the 2010 budget\textsuperscript{42}.

Federal grants-in-aid have changed over the second half of the twentieth century; their share in state and local government expenditures increased especially in the sixties. At the time, the most important grants dealt with transportation (43% of total federal grants) as the country was building its interstate highway network.

As Graph.3 shows, the share of grants-in-aid increased until 1980, driven by new block grant programs (community development) and general revenue sharing (for general government purposes), as well as many categorical grants for natural resources and the environment. In the eighties, the Reagan administration consolidated 534 categorical grants into six additional block grants, bringing the total number of grants to twelve.

Source: Data collected from the U.S. Bureau of Economic Analysis at the Department of Commerce, and computed by the author.

Since the nineties, the number of government grants has increased again, although specific data is difficult to find since the repeal of the Advisory Commission on Intergovernmental Relations in 1996. According to the data available, I estimate the current number of federal grants accessible to state and local governments between 800 and 1000 in 2009\textsuperscript{43}.

\textsuperscript{42} U.S. Office of the Budget Management, \textit{Analytical perspectives – Crosscutting programs}, 2009

\textsuperscript{43} Catalog of Federal Domestic Assistance at www.cfda.gov
To be sure, the percentage of federal grants-in-aid in the share of state and local expenditure has increased since 1990, reaching 22% in 2008 according to the Office of the Budget Management. Similarly, local governments' dependency on state aid (including pass-through grants from the federal government) escalated in the 1990’s.\textsuperscript{44}

Intergovernmental grants cover almost all areas of public service, a reason to fully understand the characteristics of each kind of grant. Most grants are either general-purpose grants or categorical grants, and there are indeed very few general-purpose grants or revenue sharing programs; in any case, they do not account for much of the total federal outlays for grants-in-aid\textsuperscript{45}. Both block grants and conditional grants are categorical grants, but with fundamental differences. The goals of block grants are broadly defined and sub-central governments can therefore use the funds at a higher level of discretion; categorical grants are intended for specific purposes, narrowly defined and distributed in two ways.

The first kind of grant is known as a formula-based (mandatory) grant. A formula-based grant is one that is established by an administrative or legislative formula. Open-ended formula grants imply that “the federal government matches all approved expenditures”\textsuperscript{46}, and matching or non-matching criteria can be in the formula. Matching criteria vary from state to state, depending on many factors such as per capita income and fiscal capacity. Therefore, matching grants force states to finance part of a government program, although the federal government pitches in considerably (usually over 50%). Matching grants represent less than half of all categorical grants\textsuperscript{47}, yet they can be fairly unpopular with sub-central governments as federal funding sometimes fails to come. The majority represent the second kind of categorical grant, known as project-based (discretionary) grants, that is, programs selectively awarded by the federal government to sub-central governments who apply to them.

Though project-based programs represent the majority of grant programs, formula-based programs are far more important in absolute amounts. Medicaid, the most expensive federal grant program, is an example; its formula includes matching criteria, forcing states to finance up to 43% of the program on average, according to the Budget Office. Table.9 shows the tremendous increase in health grants over time relative to other programs. This is due to the increase in health care costs and the increasing number of citizens qualifying for Medicaid.

Taken alone, the example of Medicaid illustrates precisely the nature of U.S. intergovernmental transfers. The program establishes a federal minimum on health care for the poor; in addition, it compels states to devote a certain amount of their revenue to the issue. There is some degree of equalization attached to the funding of Medicaid since matching requirements vary from state to state; as a matter of fact, the allocation formula includes two main elements: population size and per capita income. Table.10 clearly evidences the equalization factors contained in the Medicaid grant program.

\textsuperscript{45} Advisory Commission on intergovernmental relations, Characteristics of Federal grant-in-aid to state and local governments programs: Grants Funded FY 1995, June 1995
\textsuperscript{46} Ibid. P.11
\textsuperscript{47} This is only an estimate, for lack of proper documentation.
For instance, Kentucky, the 25th most populated state, would have a matching spending requirement equal to the nation’s average if the Medicaid allocation formula was solely based on population size. Instead, Kentucky is among those states whose matching requirement (around 30.4%) is the lowest in the U.S. But in another example, the state of Colorado, which ranks 24th in terms of population, shares half of the spending on Medicaid with the federal government, because its per capita income is the 10th highest in the nation, according to the U.S. Bureau of Census. Similarly, the two most populated states in the United States, California and New York, have the same matching requirements as Colorado, and they rank n°7 and n°4 respectively among the country’s most important per capita incomes.
The theory of fiscal federalism tends to underestimate the ability of formula-based grants to provide a certain degree of equalization; the United States grant system demonstrates this with the Medicaid program. Yet, it is true that traditional equalization grants tend to be broad-based, allowing the recipient enough leeway to spend it on issues relevant to the state or local government. The most important characteristic of U.S. federalism since the 1960’s, as I have argued so far, is that it seeks to establish minimum standards across the nation. This particularity often shades the equalization effects provided by the significant number of transfers that trickles down from the federal government to lower authorities.

Nevertheless, the logic behind intergovernmental transfers in U.S. federalism is far too complex to be simply reduced to the establishment of minimum standards and equalization objectives. Table 11 clearly shows that criteria besides per capita income and population are considered in the distribution of federal grants.

Equalization and minimum standards are obvious objectives when it comes to human and social services grants, but it is not necessarily the case for any federal grant-in-aid program.

<p>| Table 10: Federal and State Medicaid spending, FY 2007 (in millions of dollars) |</p>
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</tr>
<tr>
<td>Tennessee</td>
<td>4537.94</td>
<td>2651.68</td>
<td>7189.62</td>
</tr>
<tr>
<td>Texas</td>
<td>13514.88</td>
<td>4079.58</td>
<td>17594.46</td>
</tr>
<tr>
<td>Utah</td>
<td>675.36</td>
<td>416.33</td>
<td>1091.69</td>
</tr>
<tr>
<td>Vermont</td>
<td>532.92</td>
<td>171.41</td>
<td>704.33</td>
</tr>
<tr>
<td>Virginia</td>
<td>2811.44</td>
<td>2481.44</td>
<td>5292.88</td>
</tr>
<tr>
<td>Washington</td>
<td>2902.33</td>
<td>2888.43</td>
<td>5790.76</td>
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<tr>
<td>West Virginia</td>
<td>1582.47</td>
<td>591.25</td>
<td>2173.72</td>
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<tr>
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<td>2837.38</td>
<td>2097.77</td>
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</tr>
<tr>
<td>Wyoming</td>
<td>229.23</td>
<td>204.01</td>
<td>433.24</td>
</tr>
</tbody>
</table>

Expenditures include benefit payments and disproportionate share hospital payments; do not include administrative costs, accounting adjustments, or the U.S. Territories. Total spending including these additional items was about $331.8 billion in FY2007.

State percentage in total Medicaid spending did not appear in the original charts; I added this column using data from centroids for Medicare and Medicaid.

Source: Urban Institute and Kaiser Commission on Medicaid and the Uninsured estimates based on data from Centers for Medicare and Medicaid.
Another way to look at the issue in order to evidence that equalization is not the main goal sought by federal grant programs, is provided by the Urban Institute in a 2002 paper. This research shows the equalization potential of federal intergovernmental grants in a theoretical model. Indeed, this research evaluates the state-by-state fiscal gap, or the difference between expenditure needs and revenue capacity.

The expenditure need is calculated as a complex index including data such as poverty level, education level, and unemployment rate. The expenditure need varies considerably from state to state and there is a correlation between the highest expenditure needs and the lowest fiscal capacities. The fiscal gap at capacity evaluates the difference between expenditure needs and revenue (granted that all states followed the revenue capacity and expenditure need defined above).

Then, the authors found that the aggregated fiscal gap at capacity equaled 391 billions of dollars in 2002, while the total of

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intergovernmental grants to state was 358 billions of dollars. By reallocating intergovernmental transfers appropriately, the federal government could therefore cover 91% of the hypothetic fiscal gap at capacity existing at the state level. It should be noted that the advantage of providing a common definition of revenue effort and expenditure needs for all states could bring about incredible results to diminish interjurisdicational competition; unfortunately the federal government does not have such powers, although it could certainly redesign the allocation formulas of many of its grant-in-aid programs in order to get closer to reducing the fiscal gap.

In my point of view, what the Urban Institute’s model shows is that federal intergovernmental grants have a potentially tremendous opportunity to realize equalization based on a state’s specific needs. It is therefore fair to say that U.S. federal grants are distributed according to different logics. To that respect, Medicaid is a good example insofar as part of its matching requirement encourages states with greater capacity to finance a higher share from their own pocket, regardless to the states’ actual expenditure needs.
As a matter of fact, federal intergovernmental grants reflect no clear pattern of distribution; rather they serve multiple purposes defined independently for each program. The Urban Institute’s model underlines some aspects of the inefficiencies of the federal grant-in-aid system, but in general I find that it confirms an important devotion to establishing federal minimum standards rather than serving equalization goals.

The reason why the U.S. intergovernmental system typically aims at establishing minimum standards can be discovered in the independent nature of the various levels of government, which are likely to pursue objectives different from those of the federal government. In a discussion on the effects of block and matching grants, Michael Smart offers a very interesting insight on empirical research on the so-called “flypaper” effect of block grants: money sticks where it hits. Smart cites empirical research evidencing the principle, which implies that the funds received from a categorical block grant are spent but nothing more, whereas block grants aim to provide sub-central governments with an incentive to spend more in a given area of public services. There are contradictory empirical findings on the behavioral response of sub-central governments in terms of block grants; yet one can more easily predict the amount that will be spent by lower levels of government with a matching grant than with a block grant.

Anwar Shah demonstrates the limitations of the flypaper effect with U.S. general-purpose grants. To be sure, in 1996 the United States Aid to Families with Dependent Children (AFDC) matching grant was transformed into a block grant (Temporary Assistance for Needy Families – TANC). The AFDC’s matching rate used to be from 50 to 80 percent across states, but dwindled down to zero once it became the TANC. Shah, citing empirical from Baicker (2005), explains that the conversion from a matching grant to a block grant has increased the price of benefits and recipients by 120 percent; consequently, a 40 percent decrease of welfare cash expenditure has been noted. Baicker also found that according to the increase in the price of benefits, states have started controlling eligibility by imposing discriminatory recipient requirements, and adapted their spending according to the neighbor’s.

Therefore, the conversion to a block grant has led to a counterproductive outcome, increasing prices, lowering expenditures and triggering inefficient competition between states.

Empirical research provides important insights on how sub-central governments react to central government grants, especially in that general-purpose grants tend to be less efficient in providing incentives to increase expenditures on public welfare at the state and local level. In the United States, general-purpose grants tend to be used by sub-central governments to serve different objectives, such as tax relief for their constituents. On the other hand, there seems to be more conclusive evidence that specific purpose matching grants induce more spending from lower levels of government in the United States.

Again, the reason for this depends highly on the design of grants and the kind of accountability the federal government requires on the part of grant recipients. In any case, the U.S. grant-in-aid system shows that matching grants with narrowly defined purposes are a better tool to achieve the goals set by the federal government. We shall see in Chapter Two how this could apply to the European Union, granted the differences in objective sought

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by the European “federal” level. My hypothesis is that as opposed to the United States, the main goal of the supranational level in Europe is not to establish federal standards of expenses and welfare but rather to extend the kind of standards reached by the most advanced member-states. In this regard, the equalization objective is more relevant to the European Union than to the United States.

4. Concluding Remarks

As a mode of conclusion for this chapter, I will summarize the different logics behind federal grant-in-aid programs in the United States. As I explained previously, it is extremely challenging to confine the U.S. intergovernmental grant system to one clear pattern. Yet, several elements single out important trends in the way the system is designed. In order to define such patterns I have relied on the objective sought by the federal government, as well as on some important institutional arrangements that retain significant explanatory value. A historical perspective on federal grants-in-aid shows that the national government has played an exponential role in developing public services, according to three separate patterns.

First, from the standpoint of the theory of fiscal federalism, the federal government has typically funded initiatives to respond to the “spillover” effects of the independent initiatives of sub-central governments (the funding of highway construction, for example). The same logic applies to the environmental grant-in-aid programs developed in the 1970’s, as well as the federal government’s interest in funding education to some extent. For areas of public services involving important “spillover effects” the federal government has therefore tried to enhance “Pigouvian” transfers in order to cause sub-central governments to internalize these effects. The rationale for this type of grant lies in the federal government’s interest in providing the appropriate infrastructure to ensure the functioning of the internal market. But the federal government also has reasons to avoid the effects of interjurisdictional competition so that the different powers can maintain their tax base and their fiscal independence. On the institutional side, the Supreme Court’s jurisprudence has broadly interpreted the federal government’s competence in regulating interstate commerce, as I have shown in Section 1, thus giving a significant legal and moral authority to the federal government to regulate over externalities.

The second pattern to be drawn from a close analysis of the U.S. system is the role acquired by the federal government in times of economic stagnation. The historical fiscal data presented in this chapter clearly shows the amplified involvement of the federal government in subsidizing lower levels of government in times of economic crisis. The U.S. budget for 2009 and 2010 will not escape this rule as the American Recovery and Reinvestment Act of 2009 plans to increase intergovernmental spending up to $190.9 billion, equivalent to a 20.3% increase over two years. The reason why the federal government assumes this responsibility in times of crisis is twofold. First, the federal government does not have budget constraints and is able to run large deficits, which no state can do besides Vermont, because of self-imposed hard budget constraints. Moreover, the federal government has a larger tax base – although this tax base is more sensitive to

52 Typically highways serve more than one jurisdiction.
economic downturns for it has been relying more and more on income and payroll taxes over time. Second, the federal government is in charge of macroeconomic policy instruments that enable it to use monetary policy and interest rate policy to deal more effectively with the crisis. Combined with a fiscal effort these instruments can be decisive.

The third pattern according to which grants-in-aid are distributed occurs when the federal government seeks to establish minimum standards of public services. This way the federal government can induce sub-central governments with low welfare expenditures to increase their spending and reach a certain level of equalization, but it also betrays how the federal government has historically been a pioneer in terms of welfare programs and regulatory policy. From the theoretical point of view, the establishment of minimum standards is a safeguard against interjurisdictional competition. Indeed, in the absence of a federal standard, the different jurisdictions can be tempted to lower their welfare standard and run a “race to the bottom”.

Lastly, I would like to emphasize that the main reason why the federal government does not have a clear equalization objective is because it is more concerned with pushing forward with its own objectives than trying to close its fiscal gap with states. Sub-central governments might be considered unreliable and use such equalization grants such as block grants to cut taxes and favor horizontal competition. There are also many elements of political culture or political game favoring this kind of behavior on the part of local governments. Indeed, there is a strong correlation between the expenditure needs of a state and its revenue effort, although this correlation is not as strong as one would think. Often, states with the most important expenditure needs are also those with the lowest revenue effort; states from the Bible Belt (i.e. Louisiana, Mississippi, Alabama, Texas, Kentucky, Tennessee, South Carolina, Georgia) exemplify this correlation.

The United States’ fiscal federalism is very complex due to over two hundred years of democratic existence. Chapter one tried to make sense of this complexity by eschewing what I consider being the most crucial explanatory factors. The main conclusion I would like to emphasize is that the U.S. system is designed in a way that allows the several levels of government (federal and states especially) to pursue their own objectives, without really seeking coordination. With that in mind, I find that the federal government has grown over time and has succeeded in imposing an impressive number of federal standards, largely encroaching upon state competences. The grant system has served has a powerful instrument of soft power to impose federal preferences in many areas. I do not wish to pass any qualitative judgment here; the purpose is rather to show that fiscal federalism is much more than just a question about finding the appropriate distribution of competences across levels of government to provide public goods in the most efficient way.

In fact, the analysis conducted so far confirms the idea that the United States do not have much in common with the European Union; I shall emphasize these differences in the upcoming section and determine what kind of guidance can be applied to the European Union.

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Chapter two: Targeted Federalism: Europe’s attempt to achieve the single market and gain policy efficiency – What can U.S. experience teach?

The European Union is often referred to as a *sui generis* system, a unique experiment including characteristics from various clearly defined concepts. Although it is neither a federation nor a confederation, it borrows features from both, a reason why the European experiment ignites so much hope and promise. I think that this European form of “exceptionalism” is a recurring trait that serves the noble goal of instilling a form of pride and ownership in European citizens. It is however bound to perpetrate a few misconceptions on what some call the “European Project” (as if there were one).

There is no doubt that the Union of the European peoples, which took its first step in 1951 with the signature of the Treaty of Paris, is an exceptional experiment. It is extraordinary not only because of its “post-national” aspect, but also because of its original goal, to establish perpetual peace among nations that had been fighting world wars, with unprecedented violence, for half of a century. Nonetheless, the European Union bears resemblance to the United States in many aspects, and here one might apply Musgrave’s conception of the fundamental question animating U.S. federalism to the European Union:

“The point of departure may be one of historically given jurisdictions, each with their own history, geography, religion and ethnic characteristics. As these jurisdictions choose to enter into a federation, their respective residents, acting as groups, must decide how far they wish to go towards forming a true union. Is cooperation to be limited to matters of defense and flood control, or are all the interests of all the jurisdictions to be given weight?”

Ultimately, the kind of union born of the original compromise depends on a variety of elements; in the case of the European Union, there has not been one first compromise, but a series of numerous compromises constituting a procedure that is called the “deepening” of the Union. The common point that I find between the United States and the European Union is that they are both born from existing, independent and sovereign jurisdictions – or nations, in the European case.

This fact is crucial in determining the kind of vertical and horizontal relationships that will exist in the union. The question of “states’ rights” and “national sovereignty” are similar in nature; they are reactions to a new balance of power between the different planes of government. Such movements are symptoms of the deeper issue facing federations built upon what Musgrave describes, and evidence the fact that a federation is always in the making; it is true of both the U.S. and the EU. But the process of integration is slightly different in the European case since it is an evolution through a conceptual vagueness, where the Union must always justify its existence on the grounds of efficiency and the real “added

value” it brings to European Nations. In other words, the European Union is only the outcome of the repeated compromises and the constant quest for consensus European Nations form.

Chapter 2 will emphasize the considerable differences existing between the European Union and the United States, because a clear understanding is necessary to determine what is applicable to each model and what is not. A further difficulty in assessing these issues lays in the fact that the literature on U.S. fiscal federalism is less concerned with proving the efficiency of the federal level, mostly because of the intellectual bias towards analyzing the federal and the state level regarding their respective competences, and how these evolved over time.

A- The Community’s budget: a bargain towards significance

The European Union, like the United States, has power over monetary policy, granted by the ratification of the Maastricht Treaty in 1992 when the Euro was adopted. Another similarity to the United States lies in the Member States having retained significant independence on their fiscal policy; at the end of the day, the differences between the U.S and the EU reside in degrees of integration (of the states in the Union) and of independence (of the supranational level towards the states).

Although a matter of degree, the differences between the U.S. and the EU are important nonetheless. This section aims at providing an accurate historical background of the funding of the European Union, in order to prove its evolution towards an original form of fiscal federalism. Too often, analysts regard the European Union as being an unachieved form of federation, which should ultimately occur in the kind of arrangements at play in more “traditional” federations, like the United States.

My point of view is that the European Union bears more resemblance to the United States than is believed; their differences are a matter of history, circumstances and goals. Overall, this paper aims only to illustrate how the U.S. example can help the European Union achieve the tasks it has set before itself.

The first significant difference between the United States and the European Union is the latter’s inability to levy its own taxes. The treaties founding the Union are quite ambiguous on the functions assigned to the “Community” but definitely excluded is the “power of the purse”\textsuperscript{57}. Part 1 provides the reader with a historical account of how the European Union is funded, laying the groundwork for further analysis of the issues of fiscal federalism being faced, and what aspects of the U.S. example can offer a significant comparison to help the EU achieve its own goals.

I subscribe to the following analysis: “The evolution of the Community budget indicates the evolution of the nature of the Communities, and not the reverse.”\textsuperscript{58} The words of Menéndez imply that the European Union was founded on the notion that certain public goods should be handled at a supranational level and that this would benefit those who

\textsuperscript{58} Ibid. P.301
engaged in these common policies. The European Union was based on the pragmatic idea that a supranational union would supply a significant added value to its participants, an initiative well-aligned with the theory of fiscal federalism’s treatment of the share of the provision of public goods among the different levels of government. Although this kind of narrative is certainly not the best method to “sell” the Union to the people of Europe, it should be remembered insofar as efficiency is its prime motive.

1. The Financing experiments of the early age (1951-1975): Contributions or ‘Own resources’

The early steps of the European Community do not follow a clear pattern in terms of how to be funded. Instead, leaders betrayed a need to experiment several methods in order to select the one to be applied to a broader Union. Within a few years were created the ECSC59 (European Community of Steel and Coal, the EEC (European Economic Community) and the Euratom (European Atomic Energy Community)60. The way the three Unions arising from these treaties were funded was fragmented, betraying the indecisiveness towards the appearance of a supranational level of government.

The ECSC is significant insofar as Article 49 of its founding treaty names itself the “High Authority” to impose levies on coal and steel and subscribe loans to finance its functioning. In other words, the ECSC had great autonomy concerning its finances, although there were technical restrictions contained in Article 50 of the treaty related to an institutional mechanism required to expand the levies. The operative budget of the ECSC was handled separately from the general budget of the EEC until its expiration in 200261.

On the other hand, the EEC and Euratom were financed by MemberStates’ contributions62 according to a “scale”. Articles 200 and 2001 of the EEC Treaty also stipulated that the Commission should propose a mechanism of “own resources” to replace Member State contributions. This stipulation of the treaty was enacted in 1970 in a decision of the Council in Luxembourg63. Yet, the debate over the creation of the Community’s “own resources” had begun in 1965, when the financing of the CAP (Common Agricultural Policy) was being discussed64. The question was not resolved until Charles De Gaulle, the President of France, resigned from office in 1969; he was indeed reluctant to the creation of a Community’s power to tax, a major step towards federal Europe in his mind. Moreover, the CAP does not provide subsidies to member states but directly to individual farmers and agricultural businesses.

De Gaulle’s stepping down from office paved the way to a renewed discussion over the Community’s “own resources,” which eventually led to the 1970 Council decision, followed

59 The ECSC was signed in Paris on April 18, 1951 and went in force on July 24, 1952. The Treaty was valid for 50 years and expired on July 23, 2002.
60 These two treaties were signed in Rome in March 1957 and went in force on January 1, 1958.
62 The 1965 Merger Treaty separated the ECSC budget into an administrative and an operative budget; the administrative budget was henceforth included in the Community’s general budget (EEC and Euratom).
64 The CAP was adopted in 1962
by the July 22, 1975 decision in Brussels\textsuperscript{65}. In this period was enacted the first framework of the Community’s “own resources” system. From 1970 to 1975, the three mechanisms of the Community’s “own resources” system was progressively instated. There were three revenue sources: (1) a transfer of Customs duties to the Community, (2) agricultural levies paid in full to the Community, and (3) a VAT-based revenue limited to 1\% increasingly enforced as efforts were made to harmonize rates in the 1970’s.

The 1970 decision also stipulated that Member State contributions were to balance the Community’s budget until January 1, 1975. Starting from this date, the Community was to be financed only through “own resources”; therefore a new era began in the Community budget debate\textsuperscript{66}.

2. From “own resources” to the package DELORS I: Budgetary turmoil (1975-1988)

1975 seems to represent a landmark year for the European budget for several reasons. First, it is the official starting point of a Community exclusively funded through its “own resources”; in terms of revenue this is significant because the three levies (Customs, agricultural and VAT) create a direct link between the European people and the Community, although this was not palatable at the time\textsuperscript{67}. What is more, the promise of the Community’s “own resources” funding system appeared to trigger new developments towards more independence for the Community level, which definitely introduced significant features of fiscal federalism into the European Community.

On the expenditure side, March 1975 was marked by the creation of the European Regional Development Fund (ERDF) with its equalization goals and local governments targets. It should be noted that ERDF is still one of the major outlets of expenditure in the European Union today; it will be analyzed in greater detail in subsequent sections evaluating the nature of EU vertical transfers. Nonetheless, the European institutions remained a strong factor in preventing the Community’s take-off; indeed, the budget remained tied to the intergovernmental constraints that characterize the financial procedure, as well as Member States’ relations within the Council, as we shall later see.

As the European Commission points out, the period from 1975 to 1988 is usually seen as a time of incredible turmoil and incertitude for the future of the Community’s budget. Certainly many factors led to this situation, deceiving the hopes invested in the improvement towards budgetary independence until 1975.

The first conflicts arose over the vagueness of the 1975 decision on the definition of “compulsory” and “non-compulsory” expenditures. This distinction corresponds to the U.S. budget distinction between mandatory and non-mandatory expenditures; it serves to determine how indispensable expenditures are defined. “Non-mandatory” or “non-compulsory” expenditures are also referred to as discretionary; they vary more than compulsory/mandatory expenditures. Although an explanation of compulsory expenditure is given in Article 272 of the EC treaty as “expenditure necessarily resulting from this Treaty or from acts adopted

\textsuperscript{65} 1977 O.J. (L 359)

\textsuperscript{66} EUROPEAN COMMISSION (2008), European Union public finance; 4. ed., Luxembourg: OPOCE.

in accordance therewith”, the treaty does not envisage any mechanism to solve disputes involving the Community’s institutions.

As the Commission notes, the definition of compulsory and non-compulsory expenditures is important insofar as it draws a line between the budgetary competences of the three European institutions involved in the process (i.e. the Council of Ministers, the Commission and the Parliament). Essentially, Article 272 of the EC Treaty describes a mechanism that requires the Commission to submit a preliminary draft of the budget, which then bounces back and forth between the Council and the Parliament. The Council, who retains the final word on compulsory expenditures, then submits a first draft, and the Parliament, who presides over non-compulsory expenditures, can add spending items it deems important. However, the treaty establishes a limit on the Parliament’s capacity to add to the “balanced budget” criteria; in fact a maximum rate of increase of the non-compulsory expenditures is set by the Commission according to objective economic parameters.

Conflict arose several times between 1979 and 1987, especially after the first direct election of the European Parliament in 1979 and after it received its rather limited budgetary powers in 1975. The Council was no longer the only institution dictating the budget, whereas the Parliament, with the legitimacy conferred by its election of universal suffrage, used its budgetary powers to expand the Community’s budget, causing serious conflicts to ensue between these institutions. In order to solve these problems, the Commission, the Council, and the Parliament issued a joint declaration in 1982 expressing a (temporary) consensus on the definition of compulsory and non-compulsory expenditures.

In addition, the 1980’s saw the rise of two other major conflicts involving the participation of the United Kingdom and Germany in the Community budget. By 1980, the CAP and the ERDF had become the two major sources of expenditure for the Community, but Britain had a small agricultural sector and believed its contribution too high in comparison to the benefits it received from the EU. Moreover, constant unrest brewed about the UK’s participation in the Community, both in the political and public sphere. This resulted in what is called the British ‘rebate’, consented to by the Council in 1984 and which granted the UK: “(i) for 1984, a lump sum of 1 000 million ECU is fixed; (ii) from 1985 the gap (base of the correction) as defined in paragraph 1 is, for the period referred to in paragraph 4, corrected annually at 66%.”

Meanwhile, Germany emphasized the fact that it was the Community’s main contributor and therefore demanded a reduction in the share of the funding of the British ‘rebate’. The request was granted, as outlined in the Conclusions of the Fontainebleau Council: “The European Council asks the Commission to propose, and the Council to decide on, measures which will enable VAT relief for German agriculture under the German national budget to be increased from 3% to 5% with effect from 1 July 1984 until 31 December 1988 in compensation for dismantling the monetary compensatory amounts; the compensation shall not exceed the amounts dismantled”.

The problems faced by the Community over the budget in the 1980’s were also triggered by the rising financial needs of the Community. These problems were solved in part at the Fontainebleau Council by raising the VAT ceiling to a rate of 1.4%, and through an agreement on budgetary discipline concerning agricultural expenditures. Yet, this did not completely bury the budgetary hatchet as the European Parliament refused to recognize the conclusions of the Fontainebleau Council.

68 Conclusions of the Fontainebleau European Council, 25 and 26 June 1984. Paragraphs 2 & 3 Available at: [http://www.ena.lu/]

69 Ibid. Paragraph 5.
The conflicts were ultimately solved by what was called the “first Delors package” in 1988. A surprising detail of this era of conflict over the budget was the absence of the European Court of Justice (ECJ) as a referee for these issues.

3. The ECJ’s silence as an embodiment of the European intergovernmental/interjurisdictional practice

The title of this sub-section is actually slightly misleading, for the ECJ did express its point of view on the budgetary conflicts of the 1980’s. Yet, it must be said that all the conflicts that arose in front of the Court were ultimately removed from the register as the parties involved always found political compromises until 1986, when the ECJ finally decided to settle the case of Council v. Parliament (Case 34/86) and deliver its opinion, the first decision of the Court concerning the budgetary procedure. Many cases followed, although the ruling of the Court in this particular case clearly specified the Court’s unwillingness to get involved in questions of the budgetary procedure.

Indeed, the Court decided to adopt judicial restraint on this matter, explaining that it did not have to specify to what extent the behavior of both parties had prevented them to reach the agreement necessary on the budgetary procedure. Thus followed the opinion of Advocate General Mancini in the case, which argued that the Court should not be entrusted to rule on budget disputes because of the already too important weight it bore on the Community’s institutional framework. What’s more, the advocate general deduced that a Court’s ruling would substantially change the nature of the budgetary procedure.

The position adopted by the Court differs from the one advocated for by Mancini since the Court affirmed its jurisdiction over the case and budget disputes by extension. Nonetheless, the Court opted for a position of judicial restraint in the way it addressed the merit of the case. In effect, the ECJ affirmed that it was not obliged to rule on which party’s behavior prevented an agreement; therefore the Court decided to annul the 1986 budget on grounds of a violation of the budgetary procedure.

The ECJ further asserted that the Community budget must be adopted after a consensus has been found between the two budgetary authorities (the Parliament and the Council) after clarifying the issue of competence over compulsory and non-compulsory expenditures. This landmark ruling from the ECJ has significant explanatory value on the nature of European federalism; it is also immensely interesting in comparison to the Supreme Court’s function in the United States.

The Supreme Court of the United States, as I have explained in Chapter One, plays a significant role in the issues of federalism at play within the American union. Yet, the U.S. system depicts two distinct levels of government (federal and state) with independent taxing powers and sovereign over their respective budgetary procedure. This independence is such that the Court mostly adjudicates over the distribution of competence in terms of regulation or provision of certain types of public goods. (final sentence was repetitive)

The constitutional framework for the distribution of competence can be located in Article 5 and Article 1, Section 8 of the U.S. Constitution as well as in the 10th amendment “The powers not delegated to the United States by the Constitution, nor prohibited by it to the states, are reserved to the states respectively, or to the people.” Furthermore, there is no

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intergovernmental institution in the United States that aims at settling issues of jurisdiction over regulatory powers; thus the state and the federal level do work independently, which results in much overlapping as explained in Chapter One. Yet, federal law is sovereign over state law, to such an extent that federal law is often said to establish a minimum under which states cannot go, unless a court finds that the federal minimum exceeded the powers delegated to the federal government by the U.S. Constitution. European law benefits from the same kind of supremacy over national law, and the ECJ has the power to review and strike down national laws if they interfere with it. On the other hand, the institutional mechanisms of the European Community (and the European Union today) are such that they do not favor the clear apparition of the supranational level. As the budgetary procedure shows, the power is shared equally between a Parliament directly elected by the people and a Council of European Ministers that represents the executive body of each Member State. This difference has led many scholars to qualify the European Union as an intergovernmental system; I must add that the European Union is also interjurisdictional.

The budget process is characterized by several echelons of negotiation, which are expected to reach an agreement on the European Union’s resources. On one hand there is the intergovernmental negotiation within the Council of Ministers, and on the other hand there is the interjurisdictional negotiation, taking place between the Council, the Parliament, and the Commission, to a lesser extent. The ECJ decision in Council v. Parliament (Case 34/86) shows that the treaties are interpreted as providing an equal share of the budgetary authority between the Council and the Parliament, especially insofar as the Court insists on the necessity for both parties to reach an agreement to avoid settling a dispute on procedural grounds.

The disputes that took place before 1988 seem to prove two things about the European system. First, that the Member States (as represented by the Council) believe to have more budgetary authority because they fund the European Union in practice. This rings true in that the Union’s ‘own resources’ are in fact Member States’ resources transferred to the European Union – there exists no “European tax” as of yet. Nonetheless, the jurisprudence of the ECJ confirms that the budget is a shared responsibility of the Council and the Parliament.71

The second reason why conflicts arise can be viewed as a derivative of Brennan and Buchanan’s description of the public sector as a “Leviathan” seeking to expand its size.72 According to this analysis, the Community level (Parliament, Commission and ECJ) are seeking to expand the Community’s prerogatives. The European Parliament’s adding lines in the budget could be typically interpreted as exemplary of Brennan and Buchanan’s model. In addition, the “Leviathan” model leads Brennan and Buchanan to advocate for decentralization, as a kind of check to prevent an actual expansion of government spending. Here again, the European budgetary procedure seems to fit this model; in effect, the Council is the representing body of the Member States (a lower level of government), whereas the Parliament (the supranational body that is directly elected) tries to expand the control and spending power of the European level. Nonetheless, the ECJ’s jurisprudence in the 1980’s tends to be a contradiction to Brennan and Buchanan’s analysis in that it confirmed the necessity of consensus through bargaining between the Council and the Parliament.

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Unfortunately, a balance between the supranational and national levels hardly exists in the European Union, as lower levels of government spending and deficits evidence. This imbalance will be studied in the subsequent section.

4. A New breath: the Community budget towards the Maastricht Treaty

The Commission argued repeatedly in the 1980’s that the Community's financial crisis was due to insufficient funds from the Member States' coffers, but this issue was settled in 1988 after the Single European Act went into effect. In fact the Single European Act triggered financial reform in the European Community insofar as it expanded the goals pursued by the Community. The Act established economic and social cohesion as one of the Community’s objectives, placing the structural funds at the centre of its attention.

As a result, the Commission made specific proposals on agricultural policy, structural funds and new revenue arrangements for the Community in a communication now referred to as the “Delors package I”. Among its provisions: (1) The ceiling of Community resources was now expressed as a percentage of the total Community GNP, up to 1.15% in 1988. (2) The European VAT rate was increased from 1% to 1.27%, although the assessment basis on which each Member State will be required to pay the European VAT rate was capped at 55% of Gross National Product. (3) A fourth resource (after the customs levies, the agricultural levies and the VAT) based on a percentage of Gross National Product was added. It was a ‘balancing resource’ designed to close the gap between the expenditure needs and the revenue efforts of the Community, within the limit of the Community’s own resource (1.15%). This resource was added to make sure the Community budget was balanced; it was also a source designed to reflect adequately a country's ability to pay.

This new framework confirmed the Member States as the main financing unit in the Community, while it also reasserted the Community’s clear inclination towards redistribution. Moreover, the Commission’s leadership seemed to have led the Community out of the budgetary deadlock it was in before the Single European Act was ratified.

The growth in importance of the ERDF will be analyzed in the subsequent section as the most significant aspect of the EU's intergovernmental transfer system. On the other hand, Figure 1. demonstrates that in terms of Member State contribution, the European system was still flawed as of 1988. Indeed, as the Commission emphasized, regressive elements remained in the ‘own resources’ system since the least prosperous nations’ VAT bases were high in relation to their GNP, despite the 55% cap. This was particularly true of recent Member States such as Greece, Spain, and Ireland.

Figure 1. Structure of ‘own resources’ 1980-1992

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74 The Single European Act was signed on February 17 and 28, 1986 and came into force on July 1, 1987.

75 Named after Jacques Delors, then President of the European Commission.

Chapter two: Targeted Federalism: Europe’s attempt to achieve the single market and gain policy efficiency – What can U.S. experience teach?

5. Concluding remarks

To summarize this section, it must be said that the Council’s decision in Luxembourg in 1970 inarguably changed the nature of the budgetary procedure. Instead of a purely intergovernmental procedure (with Member State contribution) the Treaty enhanced a ‘hybrid’ model with some supranational elements. Despite the open public dispute between the Council and the Parliament, the latter was never successful in increasing the Community’s “non-compulsory” expenditures by a large margin. In fact, the Council has narrowed down any Parliamentary attempt to exceed the “maximum rate of increase”, and while the procedure does not include the Parliament in revenue decision-making, this competence pertains to the Council of European Ministers. As Pollack suggests, it would be incorrect to acknowledge the EP as an equal partner in the budgetary procedure.

The ECJ seemed to have earmarked the procedure as one of equal partnership in its 1986 Council v. Parliament decision; as a matter of fact, it did assert the Parliament’s ability to amend the budget on its first and second reading, as well as the opportunity to refuse to ratify the Council’s draft at the end of the procedure. However, the ECJ did not recognize any other role to the EP other than what is specified in the treaties, nor did it confer the Parliament any agenda-setting power or expand its aptitude to determine the Community’s revenue. The most significant aspect of European finances is beyond a doubt the absence of a supranational ‘power of the purse’ or the legal means for the only elected branch to acquire such power.

But after all, one must bear in mind that the issue of taxing and spending is always the most contentious in a federation. Alexander Hamilton expressed this very sentiment in Federalist paper n°31:

Source: European Commission

Paper presented at "Public Finances in the EU", conference organised by the Bureau of European Policy Advisers of the European Commission on 3-4 April 2008 in Brussels
“But we find, in fact, that the antagonists of the proposed Constitution... seem to make their principal and most zealous effort against this part of the plan (i.e. a general power of taxation in the national government)”79.

Considering all the elements analyzed in this section, it must be emphasized that one of the original logic in providing revenue for European expenditure is first and foremost based on the policies pushed in the European ‘common pool’. The cornerstone European integration is understood as a succession of steps on which Member States agree, but the 1980’s showed that for many Member States, European Revenue is conceived as a contribution tied to the expected benefits.

The next section is an in-depth analysis of the EU’s budget under the institutional arrangements adopted under the Maastricht treaty (1992) and subsequent treaties. Strong emphasis will be put on the nature of EU intergovernmental transfers and how they compare to U.S. vertical transfers as presented in Chapter One.

B- Making the most with very little: the European budgetary nightmare

In the wake of the first “Delors Package”, an Inter-Institutional Agreement (IIA) was pushed forward by Germany in an endeavor to secure a stipulation in the package that envisaged the creation of a multi-annual financial perspective on the budget, so as to avoid the kind of turmoil experienced in the 1980’s80.

Subsequently, a compromise was enacted for the period of 1988-1992, establishing precisely the annual spending and budget headings; the multi-annual succeeded in bringing about stability in the budget process. However, whether the agreement turned out favorably for the supranational level rests uncertain. In reality, the multi-annual perspectives anchored even more solidly the Council’s budgetary power, simultaneously weakening the EP. The initiative on revenue and the ability to set the ceiling on compulsory expenditure remained the Member States’ appanage, whilst the EP implicitly lost its ability to pressure the Council during the yearly budgetary procedure. Nonetheless, the IIAs are not legally binding for the EP, thus allowing it to threaten the Council not to comply when the latter might refuse to compromise.

In practice, the budgetary procedure has been fairly peaceful since 1988. The new treaties adopted in 1991, 1997, and 2001 did not change the budget procedure in any significant way. Within this budgetary framework, I shall now analyze the evolution of the EU’s fiscal federalism according to several factors. On the question of revenue, I shall emphasize the weaknesses of the ‘own resources’ system and its inability to provide real added value to EU membership. A comparative perspective with the U.S. will emphasize the institutional differences, which undoubtedly hold the European budget back.

On the topic of European expenditures, I will first show that the distribution reflects evident redistributive aspirations, mostly because of the level of equalization necessary to

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DUFOULON Julian
achieve cohesion in the internal market; nonetheless, I will also demonstrate that Member States pressure the EU to ensure a ‘bang for their buck’. This element relates to the idea contained within the subsidiarity principle that the Union’s legitimacy in managing public expenditure depends on the actual ‘added value’ it is likely to bring about. Then again, the efficiency criteria of the ‘added value’ principle should not be overestimated in comparison to national sensibilities within the Council. I will then draw consequences with a comparison to the United States to offer a framework of ideas to reform the role of the European Union.

1. The budgetary midget: does it really matter?

The EU Treaty establishes that “the Union shall provide itself with the means necessary to attain its objectives and carry through its policies”\(^{81}\). The EU budget represents slightly more than 1% of the total Member States GDP, which is miniscule compared to the 20% GDP the U.S. budget represents. In 2006, the total EU budget was about 129 billion Euros, approximately the amount of the United States budget for 1966. Another way to compare the EU budget is with the percentage of GDP of Member states budget, which has been around 44.5% in the EU-27 in the year 2000’s (Table.1). In total, the public sector is more important in the European Union than in the United States, yet the most significant difference rests in the share of public revenue owned by the ‘federal’ level.

Table.1 Government Revenue and Expenditure in percent of GDP 2000-2006

\(^{81}\) Article 6(4) of the Treaty on the European Union signed in Maastricht in 1992.
This has major implications for the kind of expenditures the European Union can engage in and the role it can play in the economy in comparison to the federal government of the United States. According to the 1997 MacDougal report, the EU budget should be about 2 to 2.5% of the Member States joint GDP to start having an impact on the European economy.\(^\text{82}\)

However, the comparison proves unfair since the EU is meant only to finance the programs that will bring about the objectives of the treaties. What's more, the decision-making arrangements are much different in that they include a representation of the Member State level, which has the last word on the adoption of new programs and expenditures. Since 1988, the financial perspective establishes the total level of spending and that of each heading of the budget; it is worth noting that EU spending increased from 1988 through the nineties, mostly to enforce the Treaty on the European Union and achieve the social cohesion goals required to establish the common currency. Since then, the EU revenue has

\(^{82}\) Garbriele Cipriani, *Rethinking the EU Budget: three unavoidable reforms*, Centre For European Policy Studies, Brussels (2007)
stabilized, even decreasing in relative amounts, only reaching 1.05% of EU Gross National Product for the 2007-2013 perspective\textsuperscript{63}.

According to Cipriani\textsuperscript{84}, the main issue with the financial perspective is the lack of flexibility allowed by the process. As a matter of fact, a framework that sets the levels of expenditure for a 5-year time period does not allow significant re-adjustments according to emerging priorities and conduct the necessary corrections in the European programs. He adds that the financial perspective is most certainly in contradiction to the significance of the annual budgetary procedure. This lack of adaptability clearly prevents the EU from leading temporary actions to address a pending issue; under the current framework, a European action against the economic downturn would not have been possible, as it should have waited until the next budgetary procedure, or an exceptional decision on the part of the Council. In any case, the framework does not allow important policy innovations in European macroeconomic management coming from the European institutions, which makes it difficult to prove the potential ‘added value’ offered by the supranational level.

Figure 2. EU expenditure and EU national expenditure 1996-2006

\begin{figure}[h]
\centering
\includegraphics[width=\textwidth]{figure2.png}
\caption{EU expenditure and EU national expenditure 1996-2006}
\end{figure}

\textit{Note: Data is for the EU-15 for 1996-2003 and for the EU-25 for 2004-06.}

\textit{Source: Cipriani (2007)}

Figure 2 shows how weakly correlated the different trends are. The total EU budget expenditure is almost constant from 1996 to 2006, around 1% of EU GDP, but more interestingly there is absolutely no correlation between the EU budget expenditure annual increase, the general government expenditure increase, and GDP growth.

The graph proves that EU expenditures (and therefore revenue) are not tied to economic context, but are determined by the 1.27% GNI ceiling and the financial perspective. Therefore it appears that the size of the EU budget is to be blamed on purely institutional factors and structurally unable to grow. Cipriani points the finger at another issue. Quoting the European Parliament, he affirms about the 1.27% expenditure ceiling “no budget has

\textsuperscript{63} Granted that the ceiling was set at 1.27% of EU GNP for the period 1993-1999 in Edinburgh.

\textsuperscript{84} Gabriele Cipriani is auditor at the European Court of Auditors.
ever come close to this ceiling...with payment appropriations reaching their maximum level in 1993 at 1.18% of GNP\(^{85}\).

In addition, it is quite common in the European Union to end a fiscal year with a budget surplus; according to Cipriani\(^{86}\), these surpluses have resulted in the cancellation of 40 billion Euros in payment appropriations from 1999 to 2003. Of course, a budget surplus for a fiscal year implies a diminished Member State contribution the next year.

The Court of Auditors affirmed in 2003 that the budget should not be increased each year if the Member States do not have the capacity to absorb the funds in the prescribed timeline. The Court of Auditors therefore seems to suggest that the problem with the European budget is a problem of allocation and control rather than a problem of size. The U.S. example will certainly provide some interesting insight on the problem of allocation; I will study this aspect later when considering the nature of European expenditure.

To conclude, it seems blatant that the problem is not so much that the EU budget is small, but rather that its funds are inappropriately spent. A lack of ambition reigns in the design of European policy programs. Then again, the core of the EU’s expenditure programs certainly calls for reform.

2. The debate over European ‘own resources’: the key to a more democratic Europe?

Focusing more specifically on the resources of the European Union, considerable changes have surfaced since the adoption of the ‘Delors packages’. As Table 1 (p.63) and Table 2 show, the share of each source has evolved significantly since the introduction of the third resource in 1988\(^{87}\). The VAT source dropped from 61.8% percent of EU revenue in 1992 to 16.8% in 2006 (Figure 3.), whilst the Gross National Income Resource has exponentially increased from barely 10% in 1992 to 68% in 2006\(^{88}\).

As the U.S. example clearly shows, there is a direct correlation between the ability of a level of government to raise its own taxes and the citizen’s legitimate expectations as for how these taxes will be used. I have argued that the Sixteenth Amendment establishing the federal income tax in the United States is the turning point of U.S. federalism insofar as it leveraged federal capabilities in terms of public action and made the federal government accountable in the eyes of the people. The VAT was meant to contribute to the replacement of national contributions in funding the EU, but there was little hope that the VAT would turn out to be an instrument of European autonomy: its assessment base was 1% of the hypothetical VAT base (the different VAT bases are not harmonized in Europe) and morphed into a transfer from MemberStates’ coffers. The same mechanism operated for Customs and agricultural levies. The European Union has always feared that EU revenue would be assimilated to a ‘European tax’. As Cipriani explains, the system of ‘own resources’ suggests more than what reality has brought to fruition, emphasizing the Commission’s view that the

\(^{85}\) Garbriele Cipriani, *Rethinking the EU Budget: three unavoidable reforms*, Centre For European Policy Studies, Brussels (2007)

\(^{86}\) Member of the Court of Auditors

\(^{87}\) The detail about each revenue source is provided in Section 1.

\(^{88}\) Defined in terms of Gross national Income after 1996
Union lacks a direct relationship with its citizens, who in turn do not perceive the effect of European policies.\(^8^9\)

Table 2. Composition of the EU’s ‘own resources’ 1996-2006 (In % and €Million)

<table>
<thead>
<tr>
<th>Year</th>
<th>Custom duties and agricultural levies (%)</th>
<th>VAT resource (%)</th>
<th>GNI resource (%)</th>
<th>Total (€ million)</th>
</tr>
</thead>
<tbody>
<tr>
<td>1996</td>
<td>19</td>
<td>51</td>
<td>30</td>
<td>71,177</td>
</tr>
<tr>
<td>1997</td>
<td>19</td>
<td>45</td>
<td>36</td>
<td>75,415</td>
</tr>
<tr>
<td>1998</td>
<td>17</td>
<td>40</td>
<td>43</td>
<td>82,223</td>
</tr>
<tr>
<td>1999</td>
<td>17</td>
<td>38</td>
<td>45</td>
<td>82,700</td>
</tr>
<tr>
<td>2000</td>
<td>17</td>
<td>40</td>
<td>43</td>
<td>88,040</td>
</tr>
<tr>
<td>2001</td>
<td>18</td>
<td>39</td>
<td>43</td>
<td>80,788</td>
</tr>
<tr>
<td>2002</td>
<td>12</td>
<td>29</td>
<td>59</td>
<td>77,550</td>
</tr>
<tr>
<td>2003</td>
<td>13</td>
<td>26</td>
<td>61</td>
<td>85,352</td>
</tr>
<tr>
<td>2004</td>
<td>13</td>
<td>15</td>
<td>72</td>
<td>95,201</td>
</tr>
<tr>
<td>2005</td>
<td>14</td>
<td>16</td>
<td>70</td>
<td>100,942</td>
</tr>
<tr>
<td>2006</td>
<td>15</td>
<td>17</td>
<td>68</td>
<td>102,367</td>
</tr>
</tbody>
</table>


This is reinforced by the increase of the GNI resource in the share of the EU revenue. The GNI resource is indeed a national contribution that leads Member states and their citizens to view European policies in terms of their national allocation, instead of focusing on the substance of European actions. Nonetheless, the increased share of GNI resources

\(^8^9\) Garbriele Cipriani, Rethinking the EU Budget: three unavoidable reforms, Centre For European Policy Studies, Brussels (2007)
in the total EU revenue is still a departure from the original goal to avoid direct Member State contribution.

There are several reasons why the value added has lost importance since 1988, notably because it was considered unfair to the newer poorer members (Spain and Portugal especially). The VAT is indeed a 'regressive' tax, which benefits the richest Member States. Though its significance has decreased radically, the VAT still exists today, because a unanimous vote would be necessary to abolish the tax. As a result, the VAT’s maximum call rate was reduced to 0.50% of national VAT receipts, after capping the base to 50% of GNP.

The cap was introduced in 1988, and basically made the VAT irrelevant in the sense that it was designed to be equivalent to a national contribution. As the Court of Auditors said in 1998, capping the VAT cut it from its primary function, which was to directly tax European consumption. A case has been made to revive the European VAT and make it a genuine autonomous resource. The framework proposed by the Commission in 2004 was seeking to create a 1% European VAT which would be deducted from the national VAT rate in order to keep it neutral for taxpayers\(^\text{90}\). Of course, the argument denouncing the "regressivity" of the VAT surfaced quite hypocritically, as Figure 4 clearly shows that indirect taxes have been European governments' favorite tool since 1995.

Figure 4. Evolution of direct/indirect taxation (EU-10/EU-25, GDP weighted average) 1995-2004

![Graph showing the evolution of direct and indirect taxation](image)


A debate should take place about the VAT, since it could be the first autonomous resource for the Union; this, of course, raises major sovereignty challenges at the national level. To be sure, such a change will not be accepted unless the EU institutions can prove eloquently that it would be a way for the Member States to gain efficiency. Even so, it seems

\(^{90}\) Garbriele Cipriani, Rethinking the EU Budget: three unavoidable reforms, Centre For European Policy Studies, Brussels (2007)
very unlikely that the EU institutions’ case for an actual European VAT will be welcomed warmly under the current institutional arrangements.

As a final note on the revenue aspect of the European budget, the practice developed by Member States since the British rebate in 1984 is to clamor for similar exceptions to the rule. Table 3 summarizes these exceptions granted to an increasing number of Member States. The generalization of such exceptions proves that there is a problem inherent to the system.

Table 3. Specific arrangements applicable to some member states on revenue (2007-2013)

<table>
<thead>
<tr>
<th>Member states</th>
<th>Capping of the VAT base to 50% of GNI</th>
<th>Reduced call rate of the VAT resource</th>
<th>Abatements</th>
<th>Reduced participation in bearing the cost of the UK rebate</th>
</tr>
</thead>
<tbody>
<tr>
<td>Bulgaria</td>
<td>x</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Czech Republic</td>
<td>x</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Germany</td>
<td></td>
<td></td>
<td>x</td>
<td>x</td>
</tr>
<tr>
<td>Estonia</td>
<td>x</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Greece</td>
<td>x</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Spain</td>
<td>x</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Ireland</td>
<td>x</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Cyprus</td>
<td>x</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Luxembourg</td>
<td>x</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Malta</td>
<td>x</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Netherlands</td>
<td></td>
<td></td>
<td>x x</td>
<td>x</td>
</tr>
<tr>
<td>Austria</td>
<td></td>
<td></td>
<td></td>
<td>x</td>
</tr>
<tr>
<td>Portugal</td>
<td></td>
<td>x</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Slovenia</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Sweden</td>
<td></td>
<td></td>
<td>x x</td>
<td>x</td>
</tr>
<tr>
<td>UK</td>
<td>x</td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>


In fact, Table 3 reveals all the drawbacks expressed earlier about the EU revenue system. Member state contributions tie European spending to national allocation expectation, therefore leading to claims to reduce participation when a Member State is not satisfied. The system has thus become one of country-by-country bargaining that is undoubtedly detrimental to the notion of cohesion and solidarity present in the treaties. Then
again, the rationale behind national governments’ desire to cut their European contribution usually has more to do with reaching the desired net balance\textsuperscript{91} than actual policy issues.

On this particular point too the U.S. example is relevant. Because independent resources and direct taxation of individuals, and not state contribution, allows the federal government to avoid such petty conflicts with the states. Moreover, independent resources would shift the focus of European conflicts to what should actually be the crux of European debates: the principle of subsidiarity. In other words, European debates would be revolving around which public services the European Union could provide more efficiently than the Member States.

The European Commission has proposed several new mechanisms to provide the European Union with new ‘own resources’: (1) a resource based on energy consumption, (2) a new VAT-based resource, (3) corporate income.

3. Concluding remarks

There is a lot to learn from the United States regarding the debate over the European Union’s ‘own resources’. Indeed, the federal income tax adopted with the Sixteenth amendment, provided the Federal government with the means to grow. More interesting perhaps is the fact that this tax was only supposed to compensate the decrease in revenue provoked the lowering of tariffs. Graph 1 in Chapter One showed that the Federal Income tax only became the federal government’s first source of revenue in 1945. This is not to say that European ‘own resource’ would open the door to a similar growth of the European Union's revenue, for the Council would remain the institution setting the rate. Yet, a real ‘own resource’ would lead to a more democratic Europe insofar as it would create a direct link with the European citizens, which would in turn become European taxpayers. Such an evolution would trigger the kind of accountability the European Union and many citizens are begging for.

C- EU vertical transfers: between equalization and net balances

In the previous section, I explained that the European budget is extremely small in comparison to the U.S. budget. This fact not only limits the EU’s ability to develop numerous programs but also to have a significant impact on the Community’s economy. One characteristic that is shared by the European Union and the United States is the variety of programs they both fund. Some programs are direct payments, while others correspond more to the U.S. grant-in-aid system. The European budget does not draw a clear line between aid to states and direct payments, which makes it slightly more complicated to analyze. For instance, under the Preservation and Management of Natural Resources\textsuperscript{92} heading one can find outlays that are direct payments (Common Agricultural Policy) but also intergovernmental grants to lower levels of government (the Rural Development Fund).

\textsuperscript{91} The amount received minus the national contribution.

\textsuperscript{92} The budget headings mentioned in this section are the ones retained by the financial perspective for 2007-2013; they were meant to make it easier to shift expenses within each heading.
budget heading closest to the U.S. grant system is the Cohesion for Growth and Employment Fund; I will focus mostly on this fund in the present section.

1. Convergence and Growth: the two main goals of EU spending programs

This section’s assessment of EU expenditure takes into account the numerous constraints of the revenue mechanism of the European Union; these constraints are highly political and the debate over the European Union’s ‘own resources’ will seemingly last for a long time. Indeed, the Financial Perspective for 2007-2013 has not resolved this problem and it seems like EU reform will have to take place under the current arrangements. My assessment of EU expenditures in this section aims at showing that instead of seeking new resources, major improvements are possible without necessarily increasing the European budget. In fact, it has been argued that the budget is not the most necessary element to bring about the Community’s objectives; the focus of European action usually emphasizes the regulatory aspects rather than the spending aspects that are mostly left to the Member States. However, there is a case to be made for an improvement in the way the EU allocates its resources, especially in the light of the Lisbon strategy, and the 2004 enlargement.

The Lisbon strategy puts the emphasis on growth while the 2004 enlargement extends the goals of cohesion established by the Treaty on the European Union (1992). Both these goals were addressed by the Council of Ministers with the 2007-2013 Financial Perspective as Figure 6 shows. Agriculture has always been a priority among EU expenditures, still representing 42% percent of the EU budget in 2005 (figure 5); it is however undeniable that its share in the budget has decreased significantly over time. Following the advice of the Sapir report, the share of the budget devoted to agriculture will be cut for the 2007-2013 Financial Perspective, to the benefit of the Sustainable Growth Fund (Figure 6), including a 21% raise for cohesion policy, reaching a total of 381.2 billion Euros. Conversely, the Preservation and Management of Natural Resources Fund will progressively decrease by 8% over the period from 2007 to 2013. Expenditures for the politically explosive CAP are de facto decreasing, although still insufficiently, but this is due to the complex bargaining necessary to reform the EU budget as described in previous sections.

Figure 5. Distribution of EU budget in % 2005

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Figure 6. Structure of the EU budget, Financial Perspective 2007-2013

Source: Begg, 2005

Within the Sustainable Growth Fund is privileged spending related to the development of research and development programs, but more importantly the Council increased the relative share of the Cohesion Fund. In total, the Sustainable Growth Fund will be raised by 71%.

The allocation of European funds is fairly complex and embraces a wide scope of programs, similar in nature to those existing under the U.S. system. By this, I mean to say that European outlays are allotted in the form of direct payments, project-based programs, or local government grants. I will not focus on the direct payments of the Common Agricultural Policy, although it remains the first source of EU expenditures, but rather on the Structural Funds that are the second source of expenditure.

Article 158 of the EU Treaty contends that:
“In order to promote its overall harmonious development, the Community shall develop and pursue its actions leading to the strengthening of its economic and social cohesion. In particular, the Community shall aim at reducing disparities between the levels of development of the various regions and the backwardness of the least favored regions or islands, including rural areas.”

This article betrays one of the two most important aspects of the European construction: the concern to enhance income equality across Member States. Some scholars tend to see this tendency as normative in the European Union, noting the high level of income transfers, subsidies and safety nets at play in the Member States. There may be truth to those claims, but it seems more plausible that the EU cohesion policy is determined by the necessities of the various enlargements. The main concern for ‘old’ members of the European Union is to avoid a “race to the bottom” triggered by the integration of new poorer members and their profiting from the European principles of free circulation of people, goods, and services. There is therefore a strong interest for the Union’s wealthiest nation to ensure that the new members do not lag behind.

It is nonetheless true that some degree of normative equalization is provided by the European Union through the Structural Funds, which subsidize specific regions. The Cohesion Fund, on the other hand, mainly targets the national level as the recipient of European subsidies.

Figure 7. Expenditures of Structural Funds Over Time.
However, they remain an important source of expenditure for the EU, since convergence is becoming an urgent necessity.\(^{95}\)

2. The European grant mechanism: equalization and ‘additionality’

The way European grants are allocated is extremely complex; it is almost impossible to find a complete account of the entire procedure, and the laws and communications describing it provide little more clarity. Basically, the subsidies are granted according to six “objectives”: (1) structurally adjusting regions whose development is lagging behind; (2) helping border regions or parts of regions affected by industrial decline; (3) combating long-term unemployment as well as the employment of youth and other excluded populations; (4) facilitating workers’ adaptation to structural change; (5) speeding up agricultural structure adjustment as part of the CAP program and enhancing structural changes in rural areas; and (6) promoting the development of regions with low-population density.\(^{96}\) Objectives 1 and 2 dominate the majority of the funds, yet the variety of these objectives has raised concern about the efficiency of such broad policies.

In fact, it is a characteristic of European subsidies to state and local governments to not impose a certain type of expenditure. The allocation procedure is quite stringent as to which projects will be funded, but the European Union itself does not delegate the enforcement of programs designed by EU institutions for lower levels of government. The procedure is such that in the first step, the Council submits some strategic guidelines for the spending of Structural Funds; then, eligible Member States must present a national development strategy reference document corresponding to that of the Council. Finally, Member States present the document to the Commission, where it will serve as a framework for the design of operational programs.

The main recipients of Structural Funds are regions inasmuch as the operational programs target the regions NUTS 2 and NUTS 3 mostly.\(^{97}\) Yet, EU funds are transferred to Member States on one single account, and then transferred to local governments.\(^{98}\) NUTS 2 regions receive most of the Structural Funds aid; eligible units are defined as having a GDP per capita of 75% of the EU average. All this shows the regional focus of the EU-style “grant-in-aid” system, in which Member States are only an intermediary.

Several things can be said about the Structural Funds. First, it is notable that the regional focus of the Structural Funds is so designed as to allocate funds to almost every Member State, except Denmark, Luxemburg, Belgium and the Netherlands, a satisfying explanatory factor being the intergovernmental bargains within the Council to distribute EU funds “proportionally”, with the pressure imposed by the net contributors. Second, under the

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\(^{95}\) Equalization is utterly important in the frame of the European Monetary System; especially important when the ultimate objective of integrating the new Member States in the Eurozone is considered. Important differences of development would indeed put pressure on the EU monetary policy, granted the different objectives sought by Member States. Cohesion policies are therefore of crucial importance

\(^{96}\) André Sapir et al., *An Agenda For A Growing Europe: Making the EU Economic System Deliver*, July 2003. Report of an independent High-level study group, on the initiative of the President of the European Commission.

\(^{97}\) NUTS is a statistical unit used by EUROSTAT. NUTS 1 regions correspond to the German “Bundesländer”, NUTS 2 are the equivalent of the French “régions”, and NUTS 3 correspond to the French “départements”.

regional distribution, Member States with similar GDPs can find themselves receiving very different levels of EU aid.

Another important rule of the EU cohesion policy is the “additionality” condition. This is the equivalent of matching requirements in the United States, they are not defined a priori under the EU system, but they are a condition sine qua non to keep receiving EU grants. In fact, there is a slight difference from the U.S. system, for the latter establishes the respective share of the federal government and the states in advance, whereas the European Commission only tries to make sure that EU spending does not “crowd out” national expenditure. There may be a case to be made in favor of the application of the U.S. model insofar as it allows a clear evaluation of the amount of National expenditure per Euro of Community investment. The best evaluation the Commission can come up is reproduced below in Table 4.

<table>
<thead>
<tr>
<th>Country</th>
<th>EUR of national expenditure per EUR of Community co-financing (with Cohesion Fund)</th>
<th>EUR of national expenditure per EUR of Community co-financing (without Cohesion Fund)</th>
<th>Population of Convergence regions</th>
</tr>
</thead>
<tbody>
<tr>
<td>Austria</td>
<td>5.9</td>
<td>6.9</td>
<td>277</td>
</tr>
<tr>
<td>Belgium</td>
<td>16.9</td>
<td>16.1</td>
<td>1.284</td>
</tr>
<tr>
<td>Bulgaria</td>
<td>1.3</td>
<td>2.0</td>
<td>7.781</td>
</tr>
<tr>
<td>Czech Republic</td>
<td>1.0</td>
<td>1.4</td>
<td>9.840</td>
</tr>
<tr>
<td>Estonia</td>
<td>5.4</td>
<td>9.9</td>
<td>1.956</td>
</tr>
<tr>
<td>France</td>
<td>6.7</td>
<td>5.7</td>
<td>1.798</td>
</tr>
<tr>
<td>Germany</td>
<td>7.8</td>
<td>7.8</td>
<td>15.176</td>
</tr>
<tr>
<td>Greece</td>
<td>3.6</td>
<td>4.3</td>
<td>10.202</td>
</tr>
<tr>
<td>Hungary</td>
<td>1.7</td>
<td>2.4</td>
<td>7.272</td>
</tr>
<tr>
<td>Italy</td>
<td>7.6</td>
<td>7.6</td>
<td>17.445</td>
</tr>
<tr>
<td>Latvia</td>
<td>1.6</td>
<td>2.1</td>
<td>2.313</td>
</tr>
<tr>
<td>Lithuania</td>
<td>1.1</td>
<td>1.7</td>
<td>3.426</td>
</tr>
<tr>
<td>Malta</td>
<td>1.2</td>
<td>1.9</td>
<td>401</td>
</tr>
<tr>
<td>Poland</td>
<td>1.1</td>
<td>1.6</td>
<td>36.120</td>
</tr>
<tr>
<td>Portugal</td>
<td>1.6</td>
<td>1.7</td>
<td>7.507</td>
</tr>
<tr>
<td>Romania</td>
<td>2.8</td>
<td>4.7</td>
<td>21.873</td>
</tr>
<tr>
<td>Slovakia</td>
<td>0.7</td>
<td>0.9</td>
<td>4.782</td>
</tr>
<tr>
<td>Slovenia</td>
<td>2.3</td>
<td>3.5</td>
<td>1.997</td>
</tr>
<tr>
<td>Spain</td>
<td>4.4</td>
<td>4.6</td>
<td>15.709</td>
</tr>
<tr>
<td>United Kingdom</td>
<td>9.2</td>
<td>9.2</td>
<td>2.762</td>
</tr>
</tbody>
</table>

Source: DG REGIO calculations

This table clearly shows that EU subsidies have a significant impact on New Member States or Member States whose GDP is clearly lagging behind that of ‘old members’. On the other hand, the table supports the idea that EU spending does not affect high-GDP EU members’ spending. In regards to this situation, I think the U.S. matching requirements could offer a potential solution by allowing the Commission better control over the national expenditures funded by EU subsidies and by attaching a level of expenditures from the recipient government. This way the EU could engage in subsidizing more ambitious programs defined in association with Member States’ governments (similar to the current system) and share the costs; such an option would allow the EU to shape national spending without necessarily exhausting the budget or using regulation.
As a matter of fact, European grants resemble U.S. block grants more than categorical grants. Like block grants they are tied to a general objective and are allocated to a lower level of government to implement a project and achieve these objectives. There may be slightly more control on the European side, yet the U.S. government’s threat to withdraw federal highway (block) grants in the face of state non-compliance with federal objectives in the 1960’s suggests that stringent control of block grants can be exerted on the part of the federal government.

Nonetheless, there seems to be a consensus in Europe to consider Structural Funds subsidies as theoretically different from typical equalization grants, since they are not lump-sum grants. The Sapir Report evaluated that “no strings attached” grants would not be politically acceptable in the EU insofar as the treaties do not require the equalization of levels of disposable income but of development. In addition, there is a very limited case to be made for lump-sum grants in the EU considering the volume of its budget. Furthermore, lump-sum grants would create “winners” and “losers” in the regional grant system; a Council that works with the unanimity rule concerning the planning of Structural Funds would therefore not validate this.

3. The ‘Added Value’ of the European “grant” system: assessing the macroeconomic effects

The subsidiarity principle, although broadly defined, is generally understood to provide a certain pattern of legitimation for expenditures at the supranational level. Usually, scholars refer to the necessity of the EU to bring about a significant ‘added value’ to management of public policies at the supranational level. More specifically, the Commission defines three elements EU policy should abide by to be justified theoretically:

Effectiveness – This criterion refers to what economic theory calls “spillover effects” or “externalities”. Therefore EU policy must address issues that can only be tackled at the supranational level, such as any kind of network (highways for example) or human capital investment benefiting more than one Member State.

Efficiency – EU policies must have a high ‘bang for the buck’ characteristic. The Commission names research pooling as an example.

Synergy – In other words, European policy must serve as a catalyst for national policy and enhance inter-national coordination. This criterion also implies that the supranational level can boost spending cohesion across the Union and provide incentives for better national policy as well.

101 André Sapir et al., An Agenda For A Growing Europe: Making the EU Economic System Deliver, July 2003. Report of an independent high-level study group, on the initiative of the President of the European Commission
102 André Sapir et al., An Agenda For A Growing Europe: Making the EU Economic System Deliver, July 2003. Report of an independent high-level study group, on the initiative of the President of the European Commission
In its fourth report on economic and social cohesion, the Commission affirms that European cohesion policy has achieved its objectives in a satisfying way. First, the number of objectives has been consolidated from six to three for clarity's sake. Objective 1 now corresponds to the development and structural adjustment of regions lagging behind—about 70% of the Structural Funds; Objective 2 deals with the development of border regions and regions in industrial decline; Objective 3 takes care of the adaptation and modernization of education and training systems.

Table 5. Distribution of Cohesion policy spending by domain in the EU-25, 2000-2006

As I suggested the European Commission evaluates rather positively the impact of the EU's cohesion policy; in its 2007 economic and social policy report, it affirmed that EU subsidies had fulfilled their goals therefore satisfying the effectiveness criterion. Other accounts have been provided by scholars, which offer a slightly more mitigated view.

The Commission affirms that the objectives and plan established before the period 2000-2006 were followed for the most part. The types of investment targeted were

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infrastructure, productive investment, and human capital investment. It is worth noting that this account is basically a summary of all the programs funded by EU cohesion policy, but in reality the scope of operational programs funded is extremely wide and should certainly be more targeted. It will not escape the reader’s attention that these three categories are not specific: infrastructure covers mainly subsidies for transport and environment infrastructure, productive investment is mostly composed of subsidies to Small and Medium Enterprises (SME) and research and development, and human capital investment covers mostly education and training expenditures.

Table 5 does not do an adequate job of highlighting the variety of EU cohesion spending, yet it can be observed that the overwhelming majority of regional subsidies are spent on infrastructure, of which transport represents the most significant share. Indeed, transport expenditures are easily justified in a single market seeking to realize the principle of free circulation of persons, goods and services. What is more, transnational transport networks are typically the kind of expenditures with important spillovers, thus calling for action at the supranational level.

Conversely, there is a more important balance in the policy mix subsidized by the Cohesion Fund (nationally allocated), which is split in half between environment and transport infrastructure projects.\(^{105}\)

In terms of country-by-country distribution, the Commission finds that it is too early to evaluate the performance of EU subsidies in New Member States. However, the Commission raises the issue faced in countries like Greece where productive investment was offset by a lack of adequate infrastructure.

In its macroeconomic analysis, the Commission finds a positive correlation between EU cohesion policy and GDP rates, both in the short and the long run. On the other hand, the Commission did not find conclusive evidence of significant short-term effects of EU cohesion policies on Employment. Furthermore, there are additional criteria determining the effect of EU policies independent to EU action, namely the general structure of the economy, the administrative capabilities of Member States or the technological advancement of the manufacturing sector.

The next finding of the European Commission deals with the effective incentives provided by EU spending. As I have already said, there seems to be a strong correlation between EU spending and local government expenditure. However, it must be emphasized that the data available is not always reliable and uniform across the Union. The Commission mostly used macroeconomic data to conduct its analysis of spending incentive.

Nonetheless, some studies have confirmed the Commission’s finding at least in part. Hence, Becker et al. (2008) conducted an analysis confirming at least two of the three findings of the European Commission. First, they found that the increase of per capita income provided by EU subsidies falling under Objective 1 (infrastructure) was 1.8% on average. Apart from a strong correlation between EU spending here and GDP, they also found that every Euro spent on Objective 1 transfers leads to 1.21 Euro of additional GDP. However, they did not find conclusive evidence on the effect of Objective 1 on employment. According to the authors, there are several ways to explain the phenomenon, namely that the effect on employment is to be measured over a longer time period than the sample used. Also, it is likely that Objective 1 has a more conclusive impact on investment than job creation (although one would think that the two are strongly correlated). In conclusion they

affirm that not only are Objective 1 transfers effective, but they are also cost-efficient. This diagnosis adds to the Commission’s justification of the cohesion policy.\footnote{Becker, Sascha O., Egger, Peter, Von Ehrlich, Maximilian and Fenge, Robert, Going NUTS: The Effect of EU Structural Funds on Regional Performance (December 2008). CESifo Working Paper Series No. 2495. Available at SSRN: http://ssrn.com/abstract=1314690}

In another body of research, Becker and Fuest find conclusive evidence that even in the absence of actual effects on growth and employment, specific transport subsidies from the cohesion policy successfully correct the spillovers enhanced by national transport investments. Rather surprisingly, this research also finds that EU transport policies have no effect on tax competition despite the increased mobility they allow. The authors even present scenarios under which the effects of tax competition could be mitigated by EU investments in infrastructure.\footnote{BECKER Johannes, FUEST Clemens (2008) EU regional policy and tax competition. 31 p. Paper presented at “Public Finances in the EU”, conference organised by the Bureau of European Policy Advisers of the European Commission on 3-4 April 2008 in Brussels. http://ec.europa.eu/dgs/policy_advisers/conference_docs/becker_fuest_eu_reg_policy.pdf}

On a different note, the 2003 Sapir report insisted that the data available in the different regional areas subject to the Structural Funds is not sufficient to provide a sound analysis of the impact of cohesion policies. For instance, Sapir et al. showed that Ireland and the Länder of Eastern Germany were outliers when considering the effects of EU policies on the GDP growth of regions benefiting from Structural Funds. These two regions merely drove the overall perspective up, compensating for the absence of effects in other regions such as Greece, Portugal and Spain. This analysis probably confirms the idea that there may be other factors more relevant to consider than the actual effect of cohesion policies.\footnote{André Sapir et al., An Agenda For A Growing Europe: Making the EU Economic System Deliver, July 2003. Report of an independent High-level study group, on the initiative of the President of the European Commission}

4. Conclusions on the European “grant system”: What can be learned from and for the United States?

The first element to be taken under consideration when trying to apply some aspects of the U.S. grant-in-aid system to the European Union is the difference of budgetary scale, and therefore the amount of leeway characterizing each system. In the United States, grants represent approximately 20% of sub-central government expenditures, while it barely reaches 2% in the European Union. Moreover, the European level is not as free to determine its grant policy due to the intergovernmental decision-making process (through the Council of Ministers). The EU institutions function as if the most powerful political institution in the U.S. was a representative body of the 50 governors. Therefore, EU grant policy is tied to many interests and is often the result of intense bargaining between Member States, while under the U.S. system, Representatives and, to a lesser extent, Senators act in the interest of the States. In fact, evidence suggests that some bargaining takes place under the U.S.
U.S. Intergovernmental Transfers: A Model for the European Union?

The issue with EU institutional arrangements is particularly blatant when the redistribution criteria of cohesion policy funds are considered. As a matter of fact, most of the cohesion policy is about redistributing funds to regions where the per capita income is less than 75% of the EU average; these funds can therefore be considered both as equalizing and locally targeted funds. The only issue lies in the eligibility criterion, which is designed as to distribute Structural Funds to all countries but two (Denmark and Luxembourg). This is counterproductive in many regards. First, as I have previously explained, the Structural Funds have a measured positive effect only on regions within Member States with the lowest per capita GDP; on the other hand, the impact on regions within countries with average to above-average per capita GDP is insignificant. This counterproductive situation is due to the problem of “net contributions”, where Member States request to have an acceptable return on their European contribution

Learning from the more mature American federation, it seems more efficient to determine eligibility criteria according to national (not local) data. In the United States, there is no eligibility criterion, and all states are entitled to federal aid, but grants are allocated according to different formulas (as far as conditional matching grants are concerned). These formulas can take per capita income under consideration, but also an evaluation of the cost of enforcement of the federal program, population, etc.

The challenge is to maintain the idea behind this mechanism and adapt it to the EU. In other words, I would recommend taking under consideration national data for cohesion policy and keep providing services at a local level on the same project-based basis. It would ease the tensions over “net contributions” and make European cohesion policy more efficient. Given the equalizing goal of EU grants, it would be sound to expand other European funds in which wealthier countries have more direct economic interests. This calls for more balance between European programs. Indeed some Member States’ frustration towards the EU is understandable if they do not benefit from either the Structural Funds or the Common Agricultural Policy.

Now as for the type of grants that should be favored according to the American example, it seems that the European Union already goes in the right direction. The majority of grants to state in both Unions are categorical instead of lump sum, yet the American system tends to impose matching requirements on the part of sub-central governments. A case has been made for the efficiency of these programs, and I think it should continue to be applied and enhanced according to the U.S. example for three main reasons. First, matching grants allow to ensure better control on the positive effect of federal grants on local government spending. Second, U.S. matching grants are earmarked, which allows to carry out federal goals more effectively and limit sub-central governments ability to crowd out expenditures in the subsidized policy area. Third, regarding the ongoing issue faced by European Structural

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110 André Sapir et al., An Agenda For A Growing Europe: Making the EU Economic System Deliver, July 2003. Report of an independent High-level study group, on the initiative of the President of the European Commission

111 The European equivalent for U.S. matching grants is called “co-financing” and is part of the “additionality” criterion of European aid, explained as the obligation for EU aid to avoid crowding out national expenditures.
Funds that is recipient states “absorption” capacity of Community funds, matching grants are relevant insofar as they allow the “federal” government to adjust the amounts infused\textsuperscript{112}.

The U.S. example has also proved that earmarking is an excellent way to achieve federal goals. The Commission has already acknowledged the necessity to earmark European programs to carry out the Lisbon strategy objectives. American experience also suggests that earmarking could be politically controversial in Europe since it would question the current mechanism in which National and European levels agree on projects matching the general objectives spelled out by the Council of Ministers. Yet, it would be a powerful instrument for the Union to emancipate from the straitjacket imposed by Member States through the Council of Ministers, and push forward specific European goals.

Going back to more general aspects of the two grant systems, one of the main differences is the EU’s inability to have strong macroeconomic impact on the EU economy. There are many extremely convincing arguments that can be made in favor of stronger Europe, but perhaps the most evident coming from the U.S. is the federal role during macroeconomic shocks. In a monetary union, where states cannot use monetary policy, the role of the Federal government is important to limit the effects of recession through intergovernmental transfers. This is all the more important when States are under hard budget constraints like in the EU\textsuperscript{113}, for these limit fiscal policy significantly on rainy days. Without federal grants to compensate, there is certainly an issue with limiting Member States fiscal policy.

Furthermore, the difference of scale between the two Unions pushes for more focused spending in the European Union. Indeed, the EU cannot afford the same level of variety as the United States; it does not only depend on scale but also on the Member States very high level of public expenditure. Unlike the United States, the EU does not have to force federal minima upon rather conservative sub-central governments; rather the EU must focus on increasing the efficiency of public expenditure to stir up growth across the Union. In an endeavor to achieve this goal (which corresponds that of the Lisbon Strategy) the EU should therefore focus on specific earmarked programs; doing this should not involve abandoning the project-based nature of current programs, for these allow a positive cooperation between the recipient and the provider.

Lastly, I would like to emphasize that taken in historical perspective, infrastructure programs have always been more popular in than social programs in the United States. Therefore, a good move from the European Union could be to focus even more on transportation and the environment, funding infrastructure where there are missing and insisting on environmentally friendly technology and investment. There could be a real consensus among Member States, if the EU earmarked more programs in areas where EU subsidies were proved efficient and popular.

Ultimately, an immensely interesting observation should be made in a comparison between the E.U. and the U.S. grant system. Robert Inman suggested that only part of U.S. grants to state and local governments satisfy the standards of efficiency and equity pleaded

\textsuperscript{112} The Commission and the Sapir report raise the absorption capacity problem, using EU structural funds disbursement ratio as evidence. This ratio shows that differences in terms of administrative capacity often prevent the Structural funds from being fully disbursed to recipient regions.

\textsuperscript{113} The Stability and Growth Pact adopted in 1997 with the Amsterdam Treaty limits budget deficits to 3% of GDP and public debt to 60% of GDP. The Maastricht Treaty also included the equivalent of a “no bailout clause” in Article 103 (Hallerberg, 2007).
by fiscal federalism literature. As I have advocated in Chapter One, the pattern followed by U.S. grants is difficult to assess, and unlike Europe’s, American subsidiarity does not require evidence of the increased efficiency of public service provision at the federal level to be justified. Indeed, U.S. law only requires that the federal government stays within the frame of its constitutionally delegated competences, although I highlighted that these competences had been broadly extended over time after constitutional amendments and Supreme Court jurisprudence. I would like to add that the E.U. budget’s small size is an efficient material constraint enhancing the efficiency of intergovernmental transfers.

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Conclusions: A Matter of Degree?

The Fiscal Federalism literature is based on one fundamental question: What is the appropriate level of centralization to provide public goods?

To this interrogation, the United States and the European Union supply different responses, but perhaps it should remain a question unanswered. The organization of a federal union is a bargain leading to a certain balance of power, and not simply the outcome of an academic discussion on what is the right balance in terms of efficiency and equity. This latter observation is further reinforced when a federation is the association of formerly sovereign nations. The European Union’s position is even more complicated since it is not a state but a union of sovereign people, and more than a mere international organization.

This paper did not intend to settle the perpetual political science debate about which political concept fits the European Union; and in fact looking at the question through the lens of fiscal federalism suggests that the EU is a very decentralized form of federation. In practice, the majority of public spending is effectuated by Member States, the European budget is infinitesimal comparing to other federation, and the decision-making process for EU spending is constrained by intense intergovernmental bargaining. Conversely, the federal government accounts for over half of public spending in the U.S., its budget is considerable thanks to the large base maintained by its two main taxes (income and payroll), and the federal government is independent from the states although Representatives and Senators represent their state in the U.S. Congress. Furthermore, the political divide is partisan in the United States while it is national at the European level.115

What was it then, that served as a basis to allow comparison between these two extremely different versions of the federalist concept?

In Chapter Two, I explained that to be justified, spending at the supranational level must prove that it is efficient, effective and proportionate. The first two criteria are purely economic whereas the third also involves a political aspect. From this basis it was then possible to determine which aspects of the American experiment were applicable to the European Union; although considering the greatness of the task I decided to focus on an area of fiscal federalism on which the EU and the U.S. have not often been compared: intergovernmental transfers.

What I found was that intergovernmental transfers are a reflection of the broader political, historical, and institutional compromises that define the nature of a political system. Starting from this analysis I then decided to trace back these elements and explain them to allow an assessment of what could really be applied to the European Union. I was surprised to realize that European transfers to “lower” levels of governments bear much technical resemblance to the U.S. grant-in-aid system. Yet, I was able to insist on several U.S. mechanisms, whose efficiency has been proved, and suggest their application to EU-specific goals, Convergence and Growth more specifically.

I also insisted that a possible answer to the ongoing debate about the ‘lack of democracy’ in the European Union is the creation of an actual ‘own resource’ for the European Union.

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115 There is a level of partisan divide in the European Union but regarding what interests fiscal federalism it is not necessarily relevant since the “inter-national” Council of European Minister makes decisions.
supranational level, which would no longer be a Member State’s contribution in practice. This ‘own resource’ should not serve the purpose of increasing the size of the European budget as evidence shows that this budget is not used in totality; however a genuine ‘own resource’ would allow a direct link to European citizens and trigger a demand for more accountability and European action on their part. Furthermore, it would create a form of expectation and ownership that the EU is currently lacking. I did not dwell too much on the technicalities of this issue, although it would have been a fascinating subject, because the United States would not have offered applicable guidance as for the technicalities of European ‘own resource’.

Overall, I must admit certain difficulties in the writing of this paper because of the amount of data available and the complexity of the American and the European systems. The author computed most of the tables in Chapter One; this is due to the fact that the U.S. government provides huge amounts of data, but rarely in the form of a summary. It was necessary to compute the data in order to avoid crowding the paper with countless tables and figures.

Finally, it must be emphasized that an underlying theme of this paper aims to avoid regarding the United States as a normative example. It cannot be denied that the U.S. federal system is a wonderful experience in democracy that should be imitated in numerous ways, but applying rules and principles from a foreign system is rarely successful because when it comes to politics – what works in one place will not necessarily work elsewhere. This is why the findings of this work might seem disappointing to those who expect a U.S./EU comparison to lead to the outstanding conclusion that the European Union should be the United States of Europe. If the reason for such a claim is that European growth has been generally slower than American growth, it should be noted that the objective established by the Lisbon strategy aims to change this state of fact. And there are good reasons to support a strategy that is the outcome of a European compromise, born out of the realities of the continent, instead of advocating blindly for a foreign model.

Frankly, I do not see what good normative claims urging the European Union to be a Continental version of the United States of America does for the European cause; I maintain that the context in which the EU was born requires a common political future of Europe that is yet to be invented, and that a version borrowed from the United States will ultimately prove inadequate. The European Union can only continue to exist on the condition that it justifies its value to its members. To all those who are passionate about the European project, this is exactly the kind of action necessary in order to make the experiment a true success.
Abstract

Keywords: Fiscal Federalism, Intergovernmental transfers, grants, grant-in-aid, Tax, revenue, expenditure, subsidies, government, Federalism, institutions, Member States, Europe, United States, European Union, budget, taxing power.

Intergovernmental transfers are the telltale signs of a federation’s fiscal arrangements. They reveal the balance of power and the distribution of competences within a federation. The European Union and the United States are both federations at least in fiscal terms; despite their incredible differences in centralization, it is possible draw interesting observations in order to improve the framework of European subsidies.

In explaining the major institutional, political, and historical differences between the United States and the European Union, this paper analyzes what the complicated and varied U.S. grant-to-state system can teach to the European Union. A strong emphasis is put on determining what could work given the institutional characteristics, but also given specific objectives pursued by the European Union.

Finally, this paper argues that in light of U.S. experience and European circumstances, the urgency is not for the E.U to increase the size of its budget but rather to obtain a real ‘own resource’ to create a direct relationship with the citizens of the EU and reduce its dependency on National contributions.
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