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Inefficiencies in EU's Fiscal Spending, and What Can Be Done About It

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Summary: We link inefficiencies in EU fiscal spending to the voluntary nature of international unions, which necessitates a bargaining process with national veto power. However, we show that these inefficiencies can be overcome in a union with homogeneous incomes. Therefore, our analysis suggests that increasing spending may be optimal even though it increases inefficiencies in the short run, as long as it promotes income convergence in the long run.

The European Union is unlike any national government: there is no overarching authority in the EU that can enforce efficient outcomes. Agreements over fiscal spending, for example, are a result of unstructured bargaining between member countries in which each country has the ability to veto outcomes. Despite the heated debate over EU outcomes, there is little theoretical work analyzing the basic fiscal task of raising and allocating a budget within the framework of a supranational union where, unlike a federation, sovereign countries bargain over outcomes. In recent work, we provide an underlying theory of EU fiscal negotiations by addressing the fundamental question that lie at the heart of the debate: Given competing preferences and no overarching authority, can a group of purely self-interested sovereign nations efficiently raise a budget and allocate funds?

These are highly relevant current questions. Both EU politicians and prominent European economists have called for more centralized spending at the EU level, and in early 2015 the EU Commission announced plans for a new European Fund for Strategic Investments. That fund would unlock private and public investments to a budget of at least 315 billion euro. Proponents of increasing the EU's spending capacity cite a need to counterbalance monetary policy and enforced austerity through centrally promoting cohesion and growth in low-income areas. Moreover, academics point to the benefits of centralizing some level of fiscal spending that stem from greater coordination and an ability to allocate funds to the projects that are the most deserving.

Sceptics, in contrast, point to the existing overwhelming perception that the available EU funds are inefficiently allocated, and suggesting that higher more spending is unwarranted. A prime concern, raised by both academics and pundits, is that EU funds are diverted to spending on projects in high-income countries, such as funding for art galleries in the UK, that do little to advance the stated goals of cohesion and growth. As stated by The Economist in 2007, "the scandal is not that the EU shifts money from rich countries to poorer newcomers, but that it recycles large sums straight back to wealthy countries." Others raise the concern that the EU will become a "transfer union", unjustly funneling money from the relatively rich member countries.

To give a concrete example, imagine the EU wishes to fund a transportation hub, say a new port. The spillovers from the new port will be the highest if it is located in a central country, where the port can easily be linked to the land transportation network of the EU. Many nations, however, will prefer that the port in built in their country instead, so they benefit directly from the jobs the new transportation hub will create. Of course there is also conflict over funding: each country prefers that the other countries pay for the project. A central authority would choose to build the port where it maximizes union-wide spillovers. In the EU, representatives from the individual nations bargain over the allocation of funds across various union-level projects.

Bargaining will often lead to inefficient allocations. The source of this inefficiency is that participation in the union is purely voluntary, which implies that each nation's bargaining power depends on their contribution to the central budget. That is, when nations can credibly threaten to veto the budget, their contributions to the union budget influence the de facto distribution of bargaining power over the allocation of the budget - a link that can lead to inefficient outcomes and, in particular, explains excessive spending on projects preferred by high-income countries.

More surprising is that bargaining does actually achieve efficiency in certain cases. First, if nations are symmetric with regard to income and all projects have the same level of spillovers, then the budget is raised and allocated efficiently. This follows from the fact that the bargaining positions of symmetric agents are exactly equal. Second, efficiency will be achieved when the union budget is small relative to national domestic consumption levels and income levels are comparable.

These circumstances are educational. The efficiency result for a small union budget and comparable income levels suggest that the EU might have been able to achieve efficient outcomes though unstructured bargaining in its early years. The most recent waves of expansion, however, have introduced a large degree on income inequality among member nations. In this setting, unstructured bargaining is likely to be inefficient, since too much funding will be allocated to the high-income nations.

Another important insight from our analysis is that redistribution, in the sense that some countries are net contributors to the budget while others are net receivers, arises naturally as an outcome of bargaining despite all nations being self-interested. In our model, a union can consist of net-contributing and net-receiving countries, while maintaining voluntary participation. The reason is two-fold: First centralizing spending at the union level gives countries access to benefits from coordination that no country is able to exploit on its own. Therefore, sovereign countries will participate voluntarily. Second, the allocation of the budget is a function of each country's contributions to the budget and the relative efficiency of the various projects. Therefore, countries that have access to efficient projects will end up receiving an allocation of the budget that is greater than their contribution to the joint funds.

Linking inefficiencies to the underlying bargaining structure also provide insight into how institutions might be designed to alleviate them. For example, as the EU has expanded from the original six nations to the current 28, the EU has transitioned from unanimity to qualified majority rule in many other areas of competency. Majority rule in fiscal matters can be welfare-improving since it breaks the link between contributions and allocations, at least for the nations in the minority. We show that majority rule over fiscal spending can improve efficiency as long as nations with high spillover projects are endogenously selected into the majority coalition, which occurs in equilibrium as long as the contributions to the budget by the members with efficient projects are also relatively low. Majority rule might be an appropriate institution when income and spillovers are negatively correlated.

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In the context of adopting more efficient institutions, it is important to note that unstructured bargaining is an "absorbing state," in the sense that member nations will never unanimously approve a switch to an alternative institution. Therefore, the discussion of alternative institutions is particularly relevant when considering new institutions that increase fiscal spending at the union level, such as the new European Fund for Strategic Investments: if unstructured bargaining is used initially, even though a majority rule is preferable and implementable initially, the opportunity for the EU to adopt a more efficient institution is lost.

Another factor that affects the efficiency of the allocation of the budget is the size of the union. We show that when more nations are added to the union, the return on high-spillover projects increases, shifting the resource allocation towards the efficient outcome, in line with empirical evidence that structural fund spending has been more successful in promoting growth after the expansion from 15 to 25 members. However, this channel has limited scope for decreasing inefficiency as the number of potential entrants is limited, and new countries might contribute to more heterogeneity within the EU, counteracting the benefits of increased scale.

The inefficiencies we highlight here only describe a static setting, where income inequalities are fixed. When assessing the overall desirability of fiscal spending at the EU level, it is important to also take into account dynamic considerations. Crucially, we have shown that inefficiencies in EU spending stem from heterogeneity in income levels: fiscal spending is fully efficient in a union of nations with homogenous incomes, even when they differ with regard to their relative efficiency in public goods spending. Therefore, convergence, one of the prime goals of EU fiscal spending, will mitigate the inefficiencies of fiscal spending at the supranational level.

This implies that if fiscal spending at the EU level promotes growth in the relatively low-income member nations (the empirical evidence is mixed) then an increased centralized budget, even if it is initially spent inefficiently, might be dynamically efficient. That is, when viewed in a dynamic context, a larger EU budget may increase inefficient spending in the short-run, but may speed up the process of income convergence, allowing the nations in the EU to realize the full gains of centralized fiscal spending in the long run.

References

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