

Federalism, Governance and Financial Reporting:

Where Decentralisation is not Appropriate in Regulating Financial Accounting

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Abstract

The European Union (EU) is constructed under the principle of subsidiarity. Political intervention should therefore happen primarily on a local level. With this in mind, we take a closer look at the policy field “financial reporting” and attempt to answer the question whether the current accounting regulation in Europe can be justified with the theory of fiscal federalism. For our analysis we use criteria derived from comparative accounting literature: a) The member states’ legal systems, b) the macro and micro-structure of European capital markets, c) taxation and d) financial stability (inflation). We conclude that local solutions in accounting are preferable for small and medium sized companies while big, listed firms rather need a central solution. This is due to locally different business environments in Europe on the one hand and an increasingly common capital market across the EU on the other hand.

1. Introduction

Issues of centralising and decentralising government functions are mostly discussed in connection with the idea of fiscal federalism. The theory of fiscal federalism provides a normative framework for the assignment of different government functions to an executional level (e.g. Musgrave 1959). Subsidiarity as its core principle implies that the solution of problems should be first attempted at a local level. Only in case of failure (or foreseen failure) regulation is to be delegated to a more centralised level. In the context of fiscal federalism it is commonly accepted that central governments are responsible for macroeconomic stabilisation

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and income redistribution to avoid free-rider problems (e.g. Gramlich 1987) which occur due to externalities on a decentralized level (e.g. Gordon 1982). For the majority of other fields it is argued that local politicians are closer to their constituencies' needs and therefore better capable of meeting them. Many see this advantage, in recent times promoted as "local governance" (e.g. Burchard 2001), as a means to solve problems that central governments were unable to tackle. In this vein, Oates (1999) concludes that "Fiscal Decentralisation is in vogue".

On the other hand, one can observe a development where nation state as the typical locus of central government have become too small for problem solving. In the context of the European Union (EU) and the features of its federalism, this has been discussed for, inter alia, tax competition (e.g. Goodspeed 2002), budgetary transfers (e.g. Deltas/van der Beek 2003) or the monetary union (e.g. Masson 1996). This means that there is a tension between decentralisation and Europeanisation.¹

The theory of fiscal federalism can also be useful in an allocative context where governmental decision making only has second-order distributive effects. With its stronger focus on distribution, fiscal federalism has been somewhat neglected these allocative problems. One particular case are financial markets. The Commission communication of 28 October 1998 entitled "Financial services: building a framework for action" (COM 1998 625 – final) has set out an ambitious plan which aims at a centrally set solution for a wide range of issues, among

¹ One could extend this to questions of global governance. Global Governance is a concept that is currently discussed mainly in the political sciences. It claims that problems of a certain kind cannot be solved on a local level any longer due to effects of globalisation (e.g. Mürle 1998). For an economic analysis, this implies that the question of externalities and free-rider problems has to be re-assessed taking globalisation into account. However, as global governance pre-supposes the non-existence of a functioning centre (such as a state), we find this approach too far-reaching for the question of allocating regulatory powers in a federal system.

them accounting, prospectuses, investment opportunities for insurers and pension funds, corporate governance and supervision. These European initiatives try to ensure that the single market in financial services is competitive and meets the needs of the investors, businesses and consumers. The initiatives should also make it possible to take advantage of the single currency.

In the following, we will focus on the regulation of financial reporting. From the policy-maker's point of view the function of financial reporting is to reveal information that firms would usually not disclose voluntarily (critically discussed by Healy/Palepu 2001; Watrin 2001). This information is needed for the smooth functioning of the capital markets and therefore capital allocation. Mandating firms to disclose information of a certain quality level also implies distributive effects: (a) Firms are bearing costs in order to benefit/protect outside stakeholders, which implies distributing from firms to stakeholders. (b) Informational endowments of individual stakeholders are levelled, distributing from better to less well informed stakeholders. (c) Insider knowledge about firms is made public, distributing from managers to outside stakeholders. (d) Capital maintenance rules are established, distributing from residual claimants to lenders.

Within the EU, financial reporting for firms traded on capital markets is regulated on the central level (by mandatory implementation of the International Financial Reporting Standards IFRS) and for all other companies on a decentralized level. However, this decentralized level is heavily influenced by central (EU-)directives (see e.g. Haller 2002). In the case of regulating enforcement or disclosure, there is an increasing activity of the European Commission on these issues, both due to the Lamfalussy process (e.g.

"Implementing the framework for financial markets: action plan" [COM 1999 232 final]) and in the wake of corporate accounting scandals. There is no observable trend towards decentralisation and local governance. Quite to the contrary, decision-making seems to become increasingly centralised.

In the following we want to analyse the opportunities and the obstacles of this approach of centrally establishing a single financial market. We also want to investigate where the ideas of fiscal federalism could be sensibly applied in the field of accounting thus increasing the competitiveness of the European economy. To this end, we will first review the key concepts of fiscal federalism in chapter 2. Having developed criteria for evaluating different governmental arrangements, chapter 3 turns to the range of possibilities to regulate the accounting process. These possibilities are evaluated in their institutional contexts in chapter 4. We close with conclusions in chapter 5.

2. A Review of Concepts in Fiscal Federalism

2.1. Origins of Fiscal Federalism

As an offshoot of public finance theory, fiscal federalism theory analyses the special fiscal problems which arise in federal countries, drawing on the theory of public goods, taxation and public debt incidence, public choice theories of the political process and various aspects of locational theory. More specifically, fiscal federalism theory attempts to provide criteria for an efficient assignment of functions to the various levels of jurisdictions.

With its policy focus on practical fiscal problems in federations, it is not surprising that this branch of public finance literature has flourished particularly in the North American

federations of the United States and Canada as well as in federal countries like Germany and Australia. The issue of fiscal federalism is also of relevance in countries with less well defined federal structures like Austria, India, China, Nigeria, Spain, and Switzerland.

In the EU the "Principle of Subsidiarity" is explicitly enshrined in the Maastricht Treaty as a fundamental principle for European union. In the U.S., it often appears more informally as an aversion to the "one size fits all" approach (Oates 1999). This principle of subsidiarity as an essential feature of fiscal federalism was originally based on Aristoteles and Thomas von Aquin (Becker 2003) and has modern intellectual roots in the twentieth-century Catholic social philosophy (Oates 1999). In the encyclopaedia "Quadragesimo Anno" of 1931 the principle of Subsidiarity was described as a principle implying that a shift of competences to a higher jurisdictional level is only allowed if the jurisdictions capability to act adequate cannot be assured, not even with temporary assistance of the higher jurisdiction (Becker 2003). Accordingly a shift of tasks is not allowed just because the higher jurisdiction claims to fulfil them better or more efficient than a level that is closer to the constituencies, it has to be necessary and proved (Hummer/Bohr 1992).

The economic theory of fiscal federalism is traced back to Tiebout (1956) who introduces principles for industrial policy and gives reasons for the optimal distribution of responsibilities, expenditures and income to different levels of government (Becker 2003). In his model, highly mobile households "vote with their feet": They choose as a jurisdiction of residence that particular locality which provides the fiscal package best suited to their tastes and needs. In the limiting case, the Tiebout solution generates a first-best outcome that mimics the outcome in a competitive market. Federative constitutions have therefore some

advantage over centralised ones: Public goods can be supplied with consideration of regional different preferences. Additionally, the existence of regional distinctive goods opens a door to competition between jurisdictions. But the gains from decentralization, although typically enhanced by such mobility, are by no means wholly dependent upon them (Oates 1999). In fact, if there were no mobile-households, factors or whatever, there would still exist, in general, gains from decentralization. How much of this potential can be realised depends on the distribution of governmental functions to the respective jurisdictional level.

2.2. Criteria for Policy-Makers

2.2.1. Arguments for (De-) centralisation: A Perspective from Political Science

The advantages of a federal system are a better control of power of governments and other institutions as in a centralised system. One instrument for the control of power is the separation of powers between a centre and its federal states to limit political power (Lenk 1999). Another reason for a federal structure is that democracy is more immediate. It contributes to greater transparency of political activity because devolving state functions increases the capability of constituencies to monitor their fulfilment. As local and regional governments tend to have an advantage over central governments in regard to the knowledge of peoples' needs, the political process of decision making becomes manageable and enables the citizen to participate. States with a vast geographic expansion can justify a federal system because central government is not able to react quickly on e.g. regional requests. Creating several (economic and) political centres makes it easier to balance the levels of regional development (Lenk 1999). Additionally elections on different levels strengthen the principle of democracy.

2.2.2. Arguments for (De-)centralisation: The Economic Perspective

The allocative function of the public sector is to supply the economy with particular goods and services that cannot be provided by the market because of market failure or market inefficiencies. The main reason for a gain in efficiency in federal systems is that local governments usually know best what the most urgent needs are and can therefore target the provision of public goods and services to these needs. The better matching between supply and demand of public goods in federal fiscal systems (as compared to the single uniform level provided by a single central government) should lead to Pareto-superior levels of consumption in each jurisdiction.

In decentralised systems accountability may also be higher as badly performing local governments are penalised by residents voting at local elections and/or by leaving the jurisdiction. Therefore fiscal discipline can be improved by a federal system as local governments may follow a more prudent fiscal policy than central governments. The concept denotes that the characteristics of public goods do not only apply to forms of physical supply, but also for economic conditions and objectives. This applies e.g. to the economic condition of competitive capital markets and the assigned instruments like regulation and standard setting to reach efficient capital markets (Nowotny 1997).

However there are also counter-arguments that too much fiscal decentralisation reduces efficiency. It is argued that decentralised policy making can cause macroeconomic co-ordination failures, which increase cyclicity and volatility. Furthermore excessive fiscal decentralisation leads to higher costs arising from extra-co-ordination costs and the loss of

economies of scale (as a single municipality or region may be too small to provide a good efficiently) and to an under-provision of public goods arising from external effects as the benefits are shared by other municipalities or regions which do not bear the costs. Depending on the specificities of public goods such problems may, however, be overcome at least in some cases by joint production of neighbouring local providers and/or by financial compensation between the provider and the users so that externalities are internalised. Where this is not possible a centralised provision is preferable.

Another aspect is that tax competition between jurisdictions protects tax payers from being exploited by local governments and bureaucrats which also increases efficiency (Brennan/Buchanan 1980). But there are also proponents of tax harmonisation, particular for capital income and value added taxes, who worry about a “race to the bottom”, with the result of an under-provision of public goods (e.g. Sinn 1997). However, in case of direct taxation this view is not generally shared as infrastructure competition may prevent an excessive reduction in tax rates.

Finally while in theory decentralised systems are more responsive to local citizens’ preferences this may not be the case in practice. This is the case if local officials are not elected by local citizens or if there is only limited “voting with the feet” as citizens are too poor or when labour or housing markets are too rigid. A similar case exists with mobility barriers for firms, such as taxation-on-exit or when there are excessive sunk costs. In such cases, efficiency and growth can be reduced by excessive spending of sub-national governments on wrong expenditure items.

3. Needs and Options for Regulation in Accounting

3.1. Accountability in a Contractual Framework

Accountability can be defined as the obligation to give an account. Following Perks (1993, p. 24) one can distinguish four dimensions: (1) subject of accountability (**who** is accountable), (2) the receiver of an account (**to whom**), (3) the means of accountability (**how**) and (4) the object of accountability (**for what**). The Anglo-Saxon accounting model of accountability implies that managers are accountable to the shareholders (owners) for the firm's financial performance by means of financial reports. Accounting renders an "account" of a particular financial history and maps ongoing business activities into the future. In doing this, the accounting process transforms an entity's (e.g. a firm's) economic trajectory into specific quantities (net assets and earnings – financial numbers).

Accounting Boards, be it the International Accounting Standards Board (IASB), the Accounting Standard Boards (ASB) in the UK or the Financial Accounting Standards Board (FASB) in the USA see their general objective in assuring that information about financial position, financial performance and cash flows of an entity, is useful for a wide range of users in making their economic decisions (see, e.g. IFRS-Framework). From this perspective, accounting gives third parties an idea how the company they are interested in has performed during the reporting period, how it is actually doing and how it is possibly continuing in the future, what it has accomplished, what the economic stocks of resources and obligations are and so on (Demski/Christensen 2003). This model focuses on the management of a (joint stock) company giving account to the shareholders. In its realisation the concept of accountability is threefold: It consists of the production of accounting information, the

enforcement of the production rules (e.g. by means of auditing) and rules on the disclosure of this information.

This Anglo-Saxon approach to accountability is a particular view of what accountability means and what accounting is supposed to do. Accountability can be construed in a much broader fashion. Accounts can have other objectives as well: They can be used for creditor protection, serve as a base for taxation or play a role to solve conflicts among owners or between owners and managers or other interested parties. They may inform about how socially responsible managers have acted in respect to employees, the environment, the general public, to name a few. Accountability and accounting therefore reflect a societal discourse about firms: What is to be expected from them and by whom.

There are political and cultural forces driving and, for example, (corporate) governance models reflecting this extended or differential idea of accountability. In many countries, for example, the accounting system is connected to the legal and the taxation system of the nation state (see e.g. Roberts/Weetman/Gordon 2002). Accounting extends into capital markets and company law to provide particular corporate governance mechanisms. There is the need to consider the local and global economy and the logic and needs of local and global capital markets and investors; and other institutions in national systems like collective bargaining, jurisprudence and so on. This extended concept of accountability makes accounting not only a matter of market efficiency but a policy field in its own right.

States claim to use regulation on accounting for two reasons: they optimise economic factor allocation by standardising accounting rules, and they reduce information asymmetry to

achieve a further gain in welfare. Normative theory therefore requires at least one affirmative answer to the following questions:

- Are accounting and disclosure of accounting information public goods?
- Is the market for financial information incomplete?
- Is there sufficient competition on financial markets?

Turning to the first question, we need to consider whether financial reporting can be seen as public good. Public goods are defined as free of rivalry in consumption as “...each individual’s consumption of such a good leads to no subtraction from any other individual’s consumption of that good.” (Samuelson 1954, 387, speaking of “collective consumption goods”). In regards to accounting, Gonedes/Dopuch state: “produced information is a public good” (Gonedes/Dopuch 1974, 65). But they fail to analyse the categories of “use” and “amount” of information. Only in an efficient market “...security prices at any time ‘fully reflect’ all available information.” (Fama 1970, 383), and neither “amount” nor “use” of information will be reduced under the assumption of efficient markets. But information could be used differently by different investors. This view can be justified from many different perspectives: Both the notion of semi-strong informational efficiency and Hayek’s notion of the non-existence of impartial values. Following Hayek, there are only subjective estimations and therefore expectations of market participants are heterogeneous (Hayek 1952). Market participants will use accounting information to gain stock market returns. As accounting data are used, stock market prices will reflect their usage. Therefore the usefulness of information will be reduced with its use – more and more accounting information will be “priced in”. Consequently, the pre-conditions of public goods are not fulfilled. The theory of public goods provides no justification for interventions.

Turning to the second question, it has to be considered if incomplete markets evolve from information asymmetries arising from so-called privileged market participants if no regulated financial disclosure exists. Some participants are assumed to be privileged due to their position to or in the company: a substantial shareholding, for example, enables them to communicate with the company's management in a way in which ordinary investors will not be able to. Information headstarts are corollary. This hypothesised informational asymmetry seems to hold in practice. Another reason why the state has justified its intervention in spite of the general impossibility of normative accounting standards is that there are some minority rights that might not be protected sufficiently in a non-regulatory (free market) situation. This may, however, be a red herring as it has been shown that there cannot be a "set of standards (applied to accounting alternatives *per se*) ... that will always rank accounting alternatives in relation to consistent individual preferences and beliefs." (Demski 1973, p. 722).

The third question revolves around competition in financial markets. (Financial) intermediaries such as brokers and analysts serve as producers and users of information. Additionally, trading serves as a means to factor information into share prices. A high number of intermediaries and a high volume of trading activity mean that the informational value of accounting is quickly exploited. This reduces the necessity of regulating financial reporting as it is unlikely that gains from improper reporting persist.

The analysis of capital markets not only demonstrates the difficulty to justify state intervention from a regulatory perspective, it also shows the range and the diverse nature of market participants. When state intervention is enacted by law, the process of parliamentary

debate may reduce the ability of the state to intervene in a timely and effective fashion.

Furthermore, the interests of participants in capital markets in accountability compete with others. This increased complexity may hamper effective state intervention. The hierarchical model of state intervention may not work satisfactorily in a complex environment. This does not mean that the state needs to go into retreat. Cooperative models increasingly emerge in different policy fields (Mayntz 2004). These models try to combine the state's interventionist interests with the flexibility of the private sector.

3.2. Actors in and Objects of Accounting Regulation

There are numerous reasons why national accounting regimes have developed differently in the past. These differences are discussed extensively in comparative accounting literature (see e.g. Choi 1997; Choi/Meek 2005; Gebhard 2000; Hoogendoorn 1996; Nobes/Parker 2004; Roberts/Weetman/Gordon 2002). To gain an appropriate view of the options in fiscal federalism, one additionally needs to take into account the possible actors as they also play a role in the choice of a regulatory mode.

All economic activity is conducted in the shadow of the law, and state intervention or regulation is always necessary in some form. This intervention ranges from a very low level, when contracts between individuals are enforced, to a very high one, when the state organises a set of activities by law and orders.

Table 1 provides an overview which governmental, societal and individual arrangements can be construed to regulate the accounting process.

A governmental approach to accounting regulation emphasises the hierarchical nature of the accounting process. Conflicts of interest will be solved by means of law making and regulation of state authorities. The concept of accountability (policy or content perspective) will be regulated by law, and will be “incentivised” by orders. A societal approach to accounting would leave the establishment of institutions, the definitions of procedural rules and the delineation of the accountability concept to societal groups such as standard setting bodies, the professions in a self-regulating fashion and institutions with market-making characteristics (such as stock exchanges with listing requirements). Rules will be enforced by market mechanisms such as transaction costs, cost of capital, adverse publicity and so forth. A purely individualistic approach would mean that there is no discernible regulation of the accounting process. Accounting practice is emerging, there is no (standardised) enforcement and no disclosure but a case-by-case analysis of financial reports when capital transactions are about to be undertaken.

Table 1: Approaches to Accounting Regulation (polities)

Process Step Governance Mode	Standard Setting	Enforcement	Disclosure
Governmental	Accounting rules set by law	Regulatory Authority	Disclosure stipulation by law
Societal	Private standard setting body	Auditing; Self-Regulation or Private Agency	Stock market regulation or Analyst demands
Individual	Emerging accounting	No auditing or	Transaction-based

	practice	enforcement agency	analysis
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A further distinction has to be made, and one needs to focus on the object of regulation: company accounts (those for the legal entity) and group accounts (those for the economic entity). In some countries company accounts play a major role in assessing the tax base and in resolving (potential) conflicts between owners. These owners are not, from a conceptual viewpoint, identical with (trading) shareholders. Owners are “stakeholders” in the sense that they will be connected with the company over a long time, while shareholders have no particular allegiance and will trade in their shares more quickly and easily. This means that accounting serves as a wider regulatory tool, while other countries use different functional equivalents (see e.g. Ballwieser 1997).

3.3. Policy Issues in Choosing a Regulatory Structure

The previous analysis has shown that there is a wide range of regulatory options for the accounting process. To establish a functioning (single) capital market, policy makers need to decide (i) if regulation is necessary in the first place (ii) whether a measure is undertaken at the national or the international (European) level, (iii) whether regulatory activity is conducted by private (societal) actors or by the state, and (iv) what kind of enforcement mechanisms (sanctions, adverse publicity, ...) are to be chosen.

To determine which of the choices is the most effective and efficient, policy makers need to consider the preferences of the markets in which the various rules are to be established. Policy makers further need to concern themselves with the questions whether there is sufficient competition between regions (nation states), and whether there are homogeneous preferences in *all* markets or at least in the markets under one jurisdiction. Institutional features will

reflect the different needs and preferences of the constituents and are possible drivers for a federal structure in accounting regulation. We will examine the legal system, taxation issues, the macro- and micro-structure of capital markets and financial stability (inflation) in turn.

4. Institutional Features as Drivers for a Federal Structure of Accounting in the EU

4.1. The Legal System

First one needs to consider the influence of the different legal systems. Following Parker and Nobes (2004) legal systems can be classified into two groups: the “code law” which can be found in countries like France, Italy, Germany and Spain, and the “common law”, which an Anglo-Saxon type. The latter is less abstract than the codified law; a common law rule seeks to provide an answer to a specific case rather than to formulate a general rule for use in the future. Within such a common law context accountants themselves establish rules for accounting practice, which may turn into recommendations or standards. In countries that use codified law rules for accounting and financial reporting are established as company law or commercial codes. In Germany, for example, company accounting is to a large extent a branch of company law (see e.g. Gebhard 2000).

The nature of accounting regulation in a country is therefore affected by its general legal system which enables or constrains regulatory choices. Common law countries will be able to use societal actors (such as professions) more easily as they are established “rule makers” in their own right. Code law countries will more likely have a tendency to turn to parliamentary procedures. A “one size fits all” perspective from a central government (or a supranational authority) will therefore very likely favour the code or the common law system when a

general procedure for regulation is established. The diverse nature of the legal system would indicate a need for local (decentralised) decision making. Otherwise local jurisdictions will have to bear different costs for the same type of regulation.

4.2. Macro- and Micro-Structure of Capital Markets

The macro- and micro-structure of capital markets is also a cause of international differences in accounting. Two issues need to be considered: The macro structure, i.e. the overall importance of capital markets in the economy (compared to raising funds via banks, insurance companies, ...) and the micro structure, i.e. the distribution of the supply and demand of funds within the economy (see e.g. Leuz/Wüstemann 2004). A metric for the first issue are the pension system and the saving behaviour of the general public (Boersch-Supan/Winter 2001). In societies with a high acceptance of stock-ownership as a means of saving and/or a high importance of private pension schemes (provided by firms for their employees or by financial institutions) capital markets play a much more important role and thus require more disclosure and enforcement. This is the case for the UK, while in economies like Germany's, France's or Italy's there is no broad market-driven need for information on the performance of an individual's investments.

From a microstructure perspective, those countries have relatively few listed companies, and for the existing businesses, which are often small(er) and family-owned, capital provided by banks is very significant (see e.g. Roberts/Weetman/Gordon 2002). This is how the prevalent types of business organization and ownership translate into differing financing structures: Economies with "big" capital markets tend to have businesses with a high share in equity financing; economies with "small" capital markets allocate savings via banks through debt

vehicles (see Doupnik/Salter 1995). Hence one can contrast “equity financing” and “debt financing” countries. In an extreme constellation, banks even act as equity holders when the demand for equity vehicles by individuals is particularly thin. For instance, in Germany, banks or insurance businesses are important owners as well as providers of finance.

In countries such as Germany, France or Italy, banks will often nominate directors and be able to obtain information and affect decisions (see Nobes/Parker 2004). In this case of an insider-economy the need for published information is not obvious. While one can easily see the use of disclosure for arm’s-length economies such as the UK where individual equity investors have too small a share to be (on average) influential, insider economies with their additional opportunity of obtaining inside information coupled with a negligible share of individual shareholding make disclosure near superfluous. This argument can also be extended to auditing. In arm’s-length economies the need for external verification is much higher than in insider economies. A fortiori, this is true for all enforcement activities.

However, one caveat is in order. These necessarily rough distinctions from comparative accounting research were sufficient to characterise an economy. With increasing globalisation the big companies of debt financing countries are, with their needs to raise money from all kinds of (insider, arm’s-length) capital markets, confronted with the same requirements as equity countries. The requirements of global capital markets are similar to the ones of outsider shareholders. Differences of economies play a very subordinate role for companies that are “global players”. Interestingly, fiscal federalism offers a differential answer with regards to big and small firms. From the perspective of the small firm, a locally differentiated system is advantageous; big “global” firms will best be suited by a unified and centrally set approach.

4.3. Taxation

Another important aspect that causes international differences is taxation (see e.g. Roberts/Weetman/Gordon 2002). In continental Europe (e.g. Germany, France, Belgium, Italy) tax accounts are often based on the commercial accounts (see e.g. Beaver 1998). The alternative approach, exemplified in the UK or the Netherlands, designs published financial statements mainly as performance indicators for investment decisions, and commercial accounting rules operate separately from tax rules (see Choi 1997). In such countries the taxation authorities exert at best a minor influence on financial reporting. The reverse is true when financial and tax accounting are closely aligned.

Due to the tight alignment of tax and commercial accounts, the influence of tax accounting rules means that the information content provided by financial accounts is, relatively low (see Nobes 1998). But as taxation generally relates to the taxable income of individual companies rather than that of groups, one can use consolidated accounts to provide the missing information. Since 01.01.2005 in the EU group accounts of capital market focussed groups will have to be prepared in accordance with IFRS (Prescription (EC) No. 1606/2002), and this has not met with any resistance from the tax authorities. This highlights on the one hand the importance of capital markets, and on the other hand the national sovereignty over company accounts, particular if being linked with tax accounts.

As tax-driven financial reports convey very little information that is relevant for capital markets (see Cummins/Harris/Hasset 1994), an ongoing alignment of tax and financial accounting (at least for company accounts) makes the adoption of international accepted

accounting standards in capital markets necessary, but also requires a costly operating of two systems. National taxation systems that use financial accounting make a central approach to reporting standards impossible as long as the tax systems are not aligned.

4.4. Financial Stability (Inflation)

Another factor which may affect standard setting is the level of inflation. In the English speaking world as well as many other countries like Germany and France the accounting principles have been premised on the assumption of stable price levels. However there are some countries where inflation has been overwhelming. During a period of inflation, matching revenues realized against the historical costs of resources acquired in the past when prices were lower, generally leads to an overstatement of enterprise income, which results in an increases in proportionate taxation, the requests by shareholders for more dividends, or other (Choi/Meek 2005). The most obvious feature of accounting practices to solve this problems has been the use of methods of general price-level adjustment, which was used e.g. by UK firms in the 1970s (Tweedie/Whittington, 1984). Hence without reference to inflation, it would not be possible to explain accounting differences in several countries severely affected by it (Nobes/Parker 2004). With the advent of the Euro and a general fiscal conservatism, the issue of inflation has become a non-issue.

5. Conclusion: Fiscal Federalism in Accounting - A Cost-Benefit-Analysis

A policy decision on allocating the rights for standard setting, enforcement and disclosure needs to undertake a cost-benefit-analysis. If the needs for accounting are homogeneous, a multi-level (federal) solution increases costs by increased administrative efforts and carries opportunity costs by foregoing economies of scale. These costs can only be justified if there

are welfare gains by competition between jurisdictions. Both assumptions do not hold in the European context: The analysis of the previous chapter demonstrated the diverse nature of the demand for accounting in the EU economies. Preferences and institutional settings vary widely, most markedly between arm's-length and insider economies. The macro- and micro-structure of their respective capital markets form the most important difference. A centrally set regulation will have as a consequence that *either* insider economies will disclose more information than is needed by the market *or* arm's-length economies will disclose too little information. An "intermediate" solution will produce a non-optimal level for both types of economies.

This argument, however, does not hold for big, capital-market-oriented companies in insider economies. An internationally accepted level of standards, enforcement and disclosure is necessary for these firms to raise the needed funds from capital markets. If *these* capital markets have homogeneous preferences, a central solution will serve these "global player firms" best. National jurisdictions have very little choice in allowing big companies to prepare their accounts using internationally accepted standards: Using local accounting principles increases the cost of capital and devalues the firms. The capital market misfunctions, and the amount of capital raised is less than optimal.

The conclusion therefore is twofold: Global firms need global standards, and a centrally set accounting regulation serves their needs best. Small firms in insider economies do not benefit from centrally set rules. As a consequence, they either need to be exempted – hampering their growth opportunity – or the national jurisdictions decide to change the institutional

arrangements that bear on smaller firms: a more flexible legal system, incentives to use outside finance, removing mobility barriers.

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