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Towards a European Constitution: Fiscal Federalism and the Allocation of Economic Competences

by

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Abstract

The paper analyzes one important aspect of the constitutional debate: the allocation of economic competences between the EU and the member states. It takes the theory of fiscal federalism as a starting point for an optimal allocation of economic competences. The main message of the theory is that a transfer of economic competences from a lower to a higher political level always leads to a negligence of individual preferences and, therefore, can only be economically justified if national policies cause strong spillovers (externalities) to other jurisdictions. Based on this approach, the paper proposes an allocation of economic competences that can serve as an overall guideline for a European constitution.

Keywords: European constitution; fiscal federalism; allocation of competences

JEL Classification: F15; F 42; H 11; H 23; H 77

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1. The Problem

At its meeting in Laeken in December 2001, the European Council convened a convention on the future of the European Union. The task of the convention is to pave the way for the next Intergovernmental Conference as broadly and openly as possible. It will consider key issues arising for the Union's future development, for example: what do European citizens expect from the Union? How is the division of competences between the Union and the member states to be organized? And within the Union, how is the division of competences between the institutions to be organized? This constitutional debate is timely, because more and more European citizens are looking with suspicion at the growing economic importance of EU institutions and, therefore, demand sound economic reasons for a further centralization of competences.

The objective of this paper is to provide an economic rationale for further discussions in the European Convention. The following chapter builds up a reference system — based on the theory of fiscal federalism — for an economically optimal allocation of competences within a supranational body like the EU. On basis of the theoretical analysis, chapter 3 proposes an allocation of economic competences that can serve as an overall guideline for the discussion on establishing an European constitution. Chapter 4 draws conclusions.

2. Fiscal Federalism and the Optimal Degree of Economic Integration

The process of European integration has reached a formerly unknown speed. The completion of the Internal Market has led to mutual recognition or harmonization of divergent standards, norms, and regulations among EU member countries. Moreover, the treaty of Maastricht widened the competences of the EU in various areas of economic policy. At the same time, the former EFTA-members Sweden, Finland, and Austria joined the European Union; the Central and Eastern European reform countries are determined to follow as soon as possible. Above all, the knocking-on-the door of the young market-economies in Eastern Europe has raised the question whether a widening of the integration area with countries that are lagging behind with regard to their economic development is in contradiction to a deepening of the European Union, especially with a view to the increasing centralization of economic competences on the supranational level.

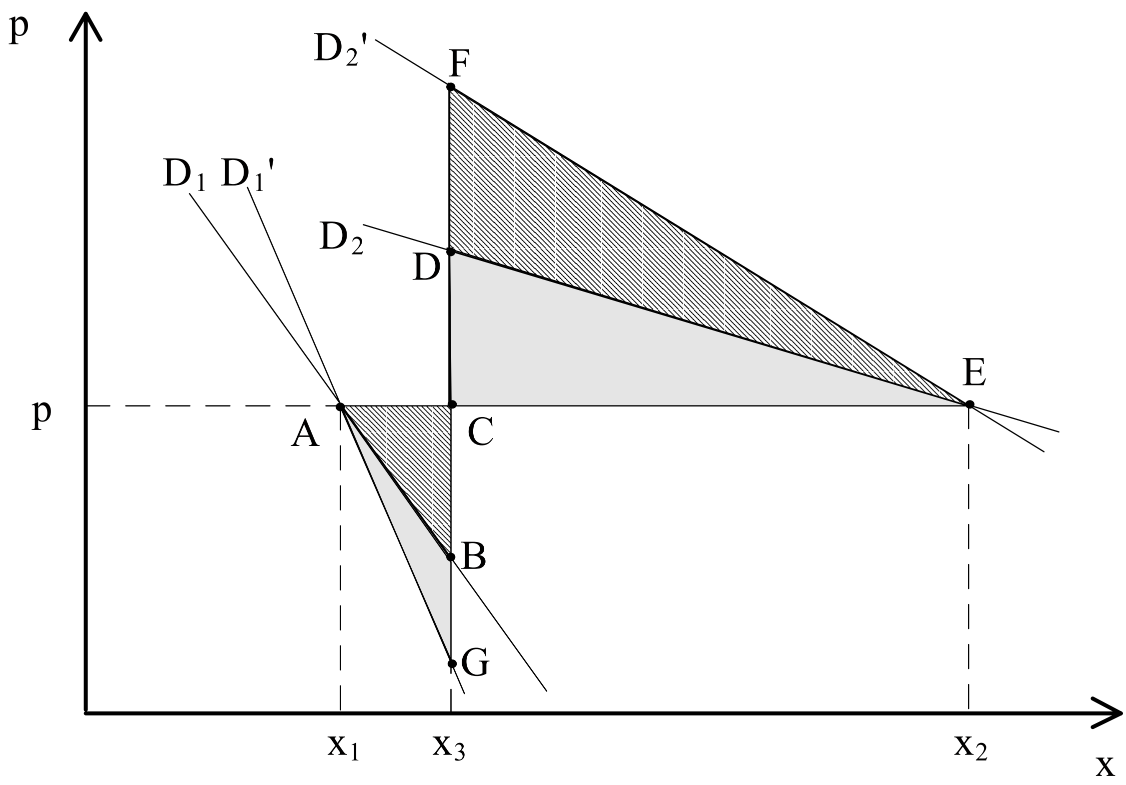
From a normative economic viewpoint, there is almost no contradiction between deepening and widening of an integration area. For economists, “deepening” means — above all — the implementation of the “four freedoms” in economic relations among member countries: the freedom of trade in goods, the freedom of trade in services as well as the free movement of capital and people across borders. Thus, a main instrument for the deepening of an integration area is the introduction of the country of origin principle.

An introduction of the country of origin principle in transborder trade between EU member countries means that all goods and services that are produced according to the norms, standards, and regulations of the exporting country can freely be shipped to any other member countries of the EU. The resulting competition of locations consequently leads to a gradual ‘market-driven’ harmonisation of differing norms, standards, and regulations between member states. In a similar vein, an introduction of the country of origin principle would result in a mutual recognition of workers’ qualifications.

The deepening of integration goes hand in hand with a transfer of certain economic competences from the national to the supranational level. It is important that the resulting distribution of competences is based on the strong economic principle of subsidiarity. The main message of this principle is that a transfer of competences from a minor to a major political level always leads to a negligence of individual preferences. If all public services are supplied by a central government body, the level of supply always reflects a compromise between varying needs of different groups of consumers. Thus, as a consequence of a transfer of competences in favour of the EU Commission, some groups of consumers become "forced riders", i.e., they are forced to consume a higher quantity of public goods and services than they prefer, while other groups of consumers will suffer from welfare losses because of an undersupply with public goods and services.

A simple graph can illustrate the welfare losses due to a centralisation of competences (Figure 1). For simplification, this graph is based upon the assumption that a nation state can be divided in two regions. Within each region, consumers' preferences with respect to the supply of public goods and services are homogenous. Thus, the curves D_1 and D_2 illustrate the demand for public goods in region 1 and 2, respectively. A central supply of public goods and services requires a political compromise between the demand of region 1, which amounts to x_1, and region 2, which is given by

Figure 1 — Welfare Losses Due to a Centralisation of Economic Competences



x_2. In case that x_3 is the compromise solution, the triangle *ABC* indicates the welfare losses per head in region 1. In this region, consumers are forced to buy more public goods and services than they wish to. The welfare losses per head in region 2 are given by the triangle *CDE* that mirrors the decrease in consumer rents due to an undersupply with public goods. This part illustrates the well-known Oates effect (Oates 1972).

In addition to the Oates effect, there is another effect that leads to additional welfare losses in case of a centralisation of competences.

Econometric studies indicate that the demand for local public goods is highly price inelastic (Rubinfeld 1987; Oates 1996). This is due to the fact that consumers can react only with a long delay to a bundle of public goods that is not in accordance with their individual preferences. Possible reaction strategies such as the migration to another region or the election of another political party either involve high adjustment and transaction costs or are only feasible once every four or five years at the end of a legislation period. The speed of reaction further decreases with a centralisation of economic competences since a voting by feet will be aggravated due to the widening of the economic area and the shrinking number of competing, geographically close regions. Moreover, in case of the EU an election of alternative supranational political leaders is only possible in an indirect way and the decision-makers that are responsible for certain economic policies are hardly to identify because supranational decision-makers are elected by (decentral) national parliaments. Under these conditions, a centralization of economic competences further reduces the elasticity of demand for public goods and services. This case is illustrated by the demand curves D'_1 and D'_2 in figure 1. The elasticity effect increases the welfare losses compared to the Oates effect to *AGC* in region 1 and *CEF* in region 2.

As a rule, the strong economic principle of subsidiarity recommends that economic competences should be transferred to the lowest possible government body. Only if a transfer of competences to the supranational level leads to efficiency gains that exceed the welfare losses due to centralization, national and regional responsibility should be replaced by supranational competences.

Above all, a centralization of tasks within the EU promises to generate welfare gains if the public services and goods supplied by one member country have the characteristics of supranational (international) public goods or lead to positive or negative transborder externalities. In these cases, there would be no incentives for a sufficient decentralized supply. There are also sound economic reasons for a centralization of competences if centralized production leads to economies of scale and the gains from scale economies compensate for the decrease of consumer rents due to a negligence of individual preferences.

The economic theory of fiscal federalism rests on the crucial assumption that a central government entity always and inevitably produces uniform goods and services for the entire jurisdiction and thus does not take into account differences in local preferences.[1] As a matter of fact, a central government is by no means obliged to produce uniform goods and services and — in the extreme case — can even regionally differentiate production so as to satisfy varying locational preferences. However, there are at least two constraints that prevent a broad differentiation of goods and services (Oates 1998). Firstly, due to imperfections in information, local governments possess knowledge of both preferences and cost conditions that a central jurisdiction is unlikely to have because they are much closer to the people and markets of their jurisdiction. Secondly, political pressures limit the capacity of central governments to provide higher levels of public services in some jurisdictions than others. Both constraints tend to require a certain degree of uniformity in central directives.

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[1] According to Breton et al. (1998) there is also another crucial assumption, namely that there are no interjurisdictional spillovers. However, as discussed above, this is not an assumption of the theory of fiscal federalism, but the most important determinant identified by this theory for an allocation of competences between different jurisdictions.

With regard to supranational policies within the EU, there is no doubt that these policies strive at harmonizing economic rules between the member states. In trade, competition and regional policy as well as in agricultural, research, and environmental policy all directives of the EU-Commission hold for all member states and thus lead to uniform economic rules across the EU. Thus, it might be justified to argue that a central government is not obliged to produce uniform goods and services, but the policy of the EU-Commission actually does tend to a harmonization of economic rules.

In addition, it is argued that the theory of fiscal federalism also rests on the assumption that there is an inverse monotone relationship between the degree of homogeneity of preferences within jurisdictions and the size of jurisdictions (Breton et al. 1998: 26). However, for the validity of the theory it is sufficient to assume that politicians choose a policy-mix that is close to the preferences of the median voter within their jurisdiction and that median preferences vary between jurisdictions. Figure 1 above illustrates that in this case a harmonization of policies leads to welfare losses for all inhabitants of the Union. With regard to the huge difficulties in finding compromise solutions on EU summits, there is almost no doubt that median preferences vary between EU member states. In this context, Oates (1998) points to the fact that the efficient level of output of a public good, as determined by the Samuelson condition that the sum of the marginal rates of substitution equals marginal costs, will typically vary from one jurisdiction to another. Thus, the economic theory of fiscal federalism might be an appropriate instrument for deriving guidelines for an optimal allocation of economic competences in the EU.

In a similar vein, Alesina, Angeloni and Etro (2001a; 2001b) formally address the trade-off between the internalisation of externalities and the costs of heterogeneity. In their models, unions like the EU are collectives of countries that decide together on the provision of certain supranational "goods" affecting all members of the Union. "Goods" in this context include traditional public goods (e.g. defence) as well as policies like legal or regulatory frameworks. In a multi country union, some competences are subtracted from national control and allocated at the union level. If the latter centralizes too many competences, several countries may not join because they are too distant from the "median" union member, given that the chosen policy is close to the median preference. On the other hand, if the union centralizes too little, it does not fully benefit from economy of scales and from externalities, which motivate the creation of a union in the first place.

3. The Allocation of Economic Competences in a European Constitution: Some Overall Guidelines

The process of European integration has gone hand in hand with a shift of economic competences from the national to the supranational level since the ratification of the Treaty of Rome. Currently the following tasks are mainly allocated to the supranational level:[2]

(1) the common trade policy vis-à-vis third countries and the liberalization of intra-community trade (trade policy);

(2) the supervision of cartels, mergers and acquisitions as well as sectoral and regional subsidies of the member states (competition policy);

(3) the allocation of regional subsidies to backward regions as a main task of the European Structural Funds (regional policy);

(4) the Common Agriculture Policy (CAP);

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[2] For an empirical analysis of the main tasks of the EU see Alesina, Angeloni, and Schuknecht (2001). The important area of monetary policy is not discussed here because an in-depth analysis of the theory of optimal currency areas would break the framework of this paper.

(5) the promotion of basic and applied research (research policy);

(6) the establishment of common norms for the protection of the environment (environmental policy).

It is obvious that the EU has taken over a broad range of responsibilities in economic policy that are by no means the result of ex ante considerations of the pros and cons of a centralization of economic competences. Thus, in course of a formulation of a European Constitution it is high time to base the allocation of economic competences on sound economic theories such as the theory of fiscal federalism. What does this theory recommend with regard to the current supranational competences of the EU?

Trade Policy

The economic theory of fiscal federalism only recommends a centralization of public tasks in case of transborder externalities, supranational public goods or scale economies resulting from centralized production. From the perspective of traditional trade theories, trade policy that aims at opening up and liberalizing national markets is neither a supranational public good nor does it cause non-pecuniary transborder externalities because the advantages of an unilateral liberalization of market access can be fully internalised by the acting country. However, the actors in commercial policy obviously do not behave as welfare theory predicts. A striking example are the high subsidies to shrinking sectors in the member states of the EU. In many industries there is even a strong subsidy competition among member states, and some countries in the EU are seeking shelters from intra-community competition by extensively using the exemption rules of Art. 115 EC-Treaty which provide a significant leeway for protectionist purposes. Obviously, politicians in the member states are driven by a neo-mercantilistic perspective of transborder trade that views a liberalization of markets as causing costs rather than causing gains.

A positive explanation for this neo-mercantilist perspective is provided by the new economic theory of politics which assumes that politicians — like other economic actors — are striving for the maximization of their own utility.[3] From the perspective of individual utility maximization it can be rational to erect trade barriers or grant subsidies in order to gain votes

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[3] See among others Niskanen (1971).

from influential interest groups. This is especially the case if the search costs that consumers and taxpayers have to bear during their attempt to get information about the effects of public protection measures are higher than the utility arising from additional information. Under these conditions, political decision-maker are more or less free to gain votes from influential interest groups without loosing support from consumers and taxpayers.

To be sure, countries that make excessive use of subsidies and protection measures will generally loose international competitiveness in the medium term and politicians will be pushed back on to the liberalization path when a potential decrease of real income makes it profitable for consumers and taxpayers to bear the high information and lobbying costs. However, these market forces are more or less toothless if member countries build up a protection or subsidy cartel by harmonizing their defensive trade and competition strategies. In this case, only an outsider, who is ready to leave the cartel and to serve as some sort of a “lender of last market” by unilaterally liberalizing his/her own home markets, is in a position to break the cartel. However, such an outsider strategy bears high risks since the short time gains from liberalization are generally relatively low, whereas the material losses of interest groups induced by a liberalization of markets are relatively high in the short run. Thus, only countries that have a long tradition in successfully liberalizing markets and that are economically strong with regard to growth and innovation will take the risk to refrain from common protection strategies. For example, the U.S. took over a leading role as an outsider in the multilateral trade negotiations within the GATT until the early eighties, because the U.S. were economically strong enough to keep special domestic interests under control and was, therefore, in a position to make the first step to a new round of worldwide negotiations by offering multilateral concessions that brought all parties back to the table.

Thus, if there is no member state within the EU that is willing to take the leading role in liberalizing markets, the utility maximisation of national politicians results in strong negative transborder externalities. In this case, only binding supranational rules that prevent an EU-wide subsidy and protection cartel will bring a supranational community back on the liberalization path. Thus, it is not the opening of markets but the utility maximization of politicians that demands a centralization of trade policy competences on the supranational level.

Competition Policy

With reference to the economic theory of fiscal federalism, there are sound reasons for a centralization of merger and cartel control on the supranational level. As a matter of fact, national merger and cartel authorities are only in a position to supervise national mergers and cartels, because they simply lack legal authority in third countries.[4] Governments that are striving for attracting additional firms from abroad are therefore tempted to loosen their competition rules in order to gain advantages in the international competition for footloose industries. Under these conditions, national competences for merger and cartel control lead to strong negative transborder externalities. Thus, the formulation and enforcement of basic European guidelines for merger and cartel control is an important supranational task. National governments that aim at establishing stronger competition rules would be free to move ahead the basic European guidelines.

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[4] For the limits of extraterritorial application of competition rules see, e.g., Klodt (2001).

With regard to the supervision of sectoral and regional subsidies, the reasoning is not as straightforward as with merger and cartel control. Since the main objective of subsidy supervision is to guarantee the functioning of the European Internal Market by preventing competition distortions, the arguments for and against a centralization of competences in this field are similar to those presented with regard to trade policy. From the strong normative viewpoint of fiscal federalism, there is no reason for supranational competences, because any single nation state would be better off if political decision-makers refrained from sectoral and regional subsidies which are not oriented at compensating market failure. However, as pointed out above, political actors obviously do not behave as welfare theory predicts. Thus, taking political economy effects into account, a supranational subsidy supervision would help to minimize negative transborder externalities stemming from the utility maximization of politicians.

Regional Policy

The regional policy of the EU is an integral part of the so-called EU Structural Funds. The main focus of the Funds is on the promotion of backward regions. Almost 70% of the total budget is granted for promoting the development and structural adjustment of backward regions, which are defined as regions with a per capita GDP of less than 75% of the EU average. Currently, eligible are — above all — the whole territory of Greece, Portugal, and Ireland, about 70% of the Spanish regions, the Mezzogiorno, the overseas departments of France, Corsica, Northern Ireland, and Eastern Germany.

From the normative perspective of fiscal federalism, there are almost no reasons for supranational competences in the area of regional policy. Externalities arising from a subsidization of local enterprises and local infrastructure projects are generally confined to the subsidized region itself. At most, externalities may arise in neighbour regions and — therefore — can generally be internalised within the borders of member states. Only in the rare case of external spillovers between border regions, interregional externalities demand an intervention of more than one member state. However, such an intervention can be confined to the establishment of bilateral rules for the internalisation of transborder externalities (Coase-Theorem) and does not necessarily imply an allocation of regional policy competences to the supranational level.

To be sure, the EU regional policy has strong redistributive effects with regard to per capita income differences among member states. Table 1 indicates that per capita transfers out of the Structural Funds increase

Table 1 — Distribution of Structural Funds among EU Member States 1994–1999

	Per capita transfers (in €)	Share of GDP (%)
Austria	40	0.23
Belgium	31	0.17
Denmark	25	0.14
Finland	67	0.47
France	37	0.21
Germany	42	0.25
Greece	279	2.79
Ireland	334	2.60
Italy	60	0.37
Luxembourg	37	0.15
Netherlands	23	0.14
Portugal	298	2.73
Spain	171	1.39
Sweden	32	0.21
UK	29	0.19

Source: Stehn (2000).

as per capita GDP declines. The same holds true for the share of transfers in national GDP. Thus, the Structural Funds do not only aim at promoting backward regions but also at redistributing funds from richer to poorer member states. With regard to the allocation of competences, there is no doubt that a redistribution of funds among member states requires a supranational body that is responsible for the formulation and enforcement of the redistribution scheme. In case of a decentralized redistribution scheme, member states would have an incentive to act as a free rider and would consequently produce negative external effects for member states acting according to the rules.

However, it makes little economic sense to base a supranational redistribution scheme on the promotion of backward regions, because decisions on the shaping of regional policies should be made by local authorities. Thus, an effective redistribution scheme should be based on unconditional transfers to poorer member states. Moreover, access to structural funds should be restricted to those member states with per capita GDP below the EU average. As a consequence, in an enlarged Union only Ireland, Spain, Portugal, Greece, and the new Eastern European members would be eligible to redistributive transfers. The size of the transfers should vary according to per capita GDP and should decrease steadily in line with growing income level in these countries. In order to partially compensate for the lost access to the funds on part of the richer member states, the total budget should be fixed at the current level so that national contributions to the EU budget can be reduced as the poorer member states catch up with their richer partners.

Common Agriculture Policy (CAP)

The objective of the Common Agricultural Policy (CAP) of the EU is to secure the income of European farmers by establishing a network of fixed, guaranteed producer prices for agricultural products, offering direct compensation payments to farmers and erecting high trade barriers for third country producers. From the normative perspective of fiscal federalism there is no reason for a centralization of agriculture support policy on the supranational level. If transborder externalities arose from a national subsidization of farmers, it would be sufficient to integrate agricultural subsidies into the general subsidy supervision of the EU (see above). Thus, responsibility for agriculture policy should be gradually shifted to the national level. A gradual reform strategy should at least include two key elements:

Firstly, CAP support prices must be reduced so that export subsidies — a necessary pre-condition for selling high-priced European products on world markets — can be eliminated. Secondly, direct compensation payments to farmers must be decoupled from production. Only by bringing down CAP support prices to world market level can the requirement for export subsidies be eliminated. At the same time, it is the only policy which will allow Europe's farmers to participate in the future growth of world markets for agriculture products. As long as there is a requirement for export subsidies, the volume of European agricultural exports will be constrained by commitments to the World Trade Organisation (WTO). Once export subsidies have been abolished, these commitments will no longer determine the volume of exports and above all Central and Eastern European producers will be in a position to become competitive suppliers on world markets. The requirement for decoupling compensation payments from production also increases with eastward enlargement. It is widely agreed that farmers in the accession countries should not receive such payments because they were not affected by reductions of CAP support prices, the original reason for the introduction of these payments. If, however, no compensation payments are made in one part of the enlarged EU, severe distortions of competition can only be avoided by a decoupling of these payments from production in other parts of the EU.

Research Policy

In the area of research and development policy, the transfer of well-defined competences might be in accordance with the strong economic principle of subsidiarity that builds the cornerstone of the theory of fiscal federalism. As empirical research indicates, basic research and development, especially in respect to high-technology R&D, can be expected to generate considerable transborder spillover effects giving rise to an almost free dissemination of basic knowledge, because basic knowledge is hard to codify and thus cannot be patented. In this case, transborder externalities can lead to an under-investment in basic research activities which can only be prevented by a transfer of responsibilities from the national to the supranational level. However, in order to internalize transborder externalities it is sufficient to make the supranational level responsible for raising and allocating financial funds for research and development. Decisions on the special characteristics of research projects should be made on the national or regional level, because preferences might differ among member states or regions.

Moreover, there are complaints that some countries are hindering the free dissemination of basic R&D findings. Since basic knowledge is a prerequisite for successful applied research, this collusion behaviour might give the participating firms a competitive edge on future product markets. As a matter of fact, there is an obvious contradiction between the empirical finding that basic R&D generates transborder spillover effects and the proposition that some countries are hiding away basic research findings from competitors abroad. However, the general finding of an observable transborder dissemination of basic knowledge does not mean that a formation of successful research cartels is impossible at all. If cartels are in a position to bind their researchers to the cartel on cultural, moral, or contractual grounds, it may be possible to hinder the free dissemination of basic knowledge, at least for some time. Hence, there are some good reasons for a supranational subsidy supervision in the area of research and development policy.

However, there are no economic reasons for a supranational promotion of applied research, because gains from the invention of codifiable and tradable products and production processes can generally be internalized by the inventor.

Environmental Policy

There is no doubt that environmental pollution causes negative external effects; in the case of air and water pollution these external effects often even spill over national boarders. Thus, a centralization of environmental policy competences in the area of transborder pollution is welfare enhancing. However, this does not hold for environmental pollutions that are confined to single regions or member states. In these cases, the externalities can be internalised on a regional or national level.

Moreover, most current environmental subsidies are granted to facilitate the adaption of enterprises to new environmental standards that have been set by legal rules. In other words, governments are striving for lowering the costs that enterprises have to bear due to the setting of new environmental standards. This is by no means an efficient policy, even from a purely domestic perspective, because it only aims at improving the competitiveness of domestic firms at the expense of competitors abroad. A first-best policy would be to define prices for environmental resources by taxing the source of environmental pollution. Thus, there are sound economic reasons for a supranational supervision of environmental subsidies that prevents an abuse of environmental policy for protectionist purposes.

4. Conclusions

In this paper, a theoretical reference system was developed that allows for assessing the effectiveness of EU policies with regard to an efficient allocation of economic competences between the EU and the member states. The reference system is mainly based on the theory of fiscal federalism. Its main message is that a transfer of economic competences from a minor to a major political level always leads to a negligence of individual preferences and, therefore, can only be economically justified if national policies lead to strong transborder externalities. It was demonstrated that the deepening of the integration process involves significant jurisdictional shifts from member states to the EU that are not justified on economic efficiency grounds. In many areas the strong economic principle of subsidiarity is violated by an increasing tendency of the EU to rely on market intervention. Thus, an European constitution should aim at strengthening the trade and competition policy as well as the subsidy supervision of the EU and at reducing direct market interventions resulting from active industrial policies.

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