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Comment on Robin Boadway: The principles and practice of federalism: Lessons for the EU?

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Robin Boadway's thorough and thoughtful survey of fiscal federalism is useful when thinking about the assignment of functions between different political levels in a true federal system or in a unitary state like Sweden. All countries need to weigh the advantages and disadvantages of allocating different kinds of political decision making to the central and lower levels of government.

But, as Boadway points out himself, such a survey is less relevant when thinking about the EU. Despite the efforts of the EU federalists, the EU is not a federation. Nor is it likely, I do not think, to ever become one. The resounding "no" to the proposed EU constitution in the recent referenda in France and the Netherlands, two of the EU's core countries, has at least temporarily put a stop to that. Continued enlargement, making the EU even larger and more heterogeneous, is likely to make it impossible even in the more distant future. There is simply not enough political and social cohesion among this large collection of diverse nation states for them to accept a strong central government with decision-making power of its own.

The paper emphasizes that there are three defining features of federations which are important to fiscal decision making. The first is the existence of a strong federal government with strong taxing power and with some decision-making authority (financial, regulatory or legal) over the states. The second is the existence of redistributive transfers from the federal level to the states, which will equalize the capacity of states to deliver comparable levels of public services. The third is that citizens in a federation enjoy national citizenship and all the economic and social rights that go with it.

To this, I would like to add a fourth criterion, namely, that whichever political level has the right to decide over certain expenditures is also charged with the responsibility of financing most of these expenditures. Decision makers need to take account not only of the benefits of public spending but also their tax costs and be held politically accountable by citizens for both decisions. By the first three criteria,

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there is a large number of very diverse federations. The fourth criterion reduces the number of genuine federations to a very small number, among which are Canada, Switzerland and the US.

The EU fails on all of these criteria. The EU does not have a federal government, nor does it have taxing power. The EU does not attempt to equalize the fiscal capacity of its member states through redistributive transfers (although the structural and cohesion funds can be seen as a modest attempt in that direction). Nor does the EU have as a goal to ensure equal social protection across the member states.

The EU is not a federation, nor is it a union of equals as in a confederation. At the same time, it is more than an economic union joined together by an integrated market with the free flow of goods and services, capital and labor. It is a hybrid. In some areas, decision making is clearly federal. For example, decisions are made by EU institutions without the control of member states in areas where the EU level has exclusive decision making authority, notably by the Commission in trade policy and competition policy and by the European Central Bank in monetary policy for the Euro area. Also, the EU court is the highest adjudicator of EU law. In a large and growing number of other areas, decisions are taken by qualified majority in the European Council and these decisions supersede national law. In yet other areas, notably taxation, foreign policy and defense, unanimity among member states is required.

Is it a viable hybrid? We do not know yet. Some people warn that the absence of the kind of constitutional constraints that exist in most federal systems means that there is a risk that the EU will tip in the direction of uncontrolled centralization. Such centralization will create political tensions in and between member states which, in turn, may lead to disintegration. (Persson et al., 1999)

What seems clear is that the EU is in many ways a unique experiment: it is rare that countries voluntarily give up sovereignty over national policy to a super national organization. History, even recent history, is replete with examples of unions and countries that have moved in the opposite direction and broken up into their component parts; the former Soviet Union, the former Yugoslavia and Czechoslovakia to mention a few. Separatist movements are strong in many countries. The US fought a civil war which was very bloody in order to preserve the union. Sweden and Norway broke up peacefully 100 years ago.

The uncertainty about where the EU is heading, and should be heading, is a good reason for this conference. It is also what the member states ought to be discussing during the "period of reflection", which the EU leaders have called for after the collapse of the proposed EU constitution.

So, what can we learn from political economy and fiscal federalism on the question of "what should the EU do"? What are the economic arguments for delegating powers from the national to the EU level?

The paper does not explicitly address this normative question but leaves it to the reader to draw his or her own conclusions about what parts of the fiscal federalism analysis are relevant to the EU. So, that is what I will do here. I will spell out the lessons of fiscal federalism, as I see them, for the EU.

1. The assignment problem

The proper assignment of taxation and public spending powers between different political levels in a union is central to fiscal federalism. There are efficiency arguments in favor of both decentralization and centralization. To summarize:

Motives for decentralization:

- Heterogeneous preferences combined with information advantage of local decision makers;
- Experimentation and institutional competition when diverse solutions are allowed;
- Political accountability and citizen participation in the political process, which is easier in smaller jurisdictions.

Motives for centralization:

- Internalizing geographic spill-over effects of public goods and services;
- Reducing tax and benefit competition to attract mobile labor and firms;
- Redistribution, including social insurance, to ensure that social services delivered locally are consistent with national goals;
- Stabilization policy.

Preference heterogeneity is crucial. If there is no heterogeneity, the identical service could be supplied throughout the federation with no efficiency loss. Alesina and Spolaore (2003) argue that preference heterogeneity is an important determinant of the optimal size of nations. Boadway does not think there is much evidence of preference heterogeneity in federations. I do not know to what evidence he is referring, but I have the opposite impression. Political majorities vary between local and state governments as do ways of doing things, which presumably reflects different preferences. This is true in federations like the US and Switzerland, but it is also true in more homogeneous countries like Sweden. In the case of the EU, I do not think anyone would dispute that heterogeneity of preferences and traditions is very great.

The importance of institutional competition should not be underestimated either. We rarely know the best way of achieving an objective, whether it be price stability, low unemployment or quality health care, and trial and error *on a small scale* is better than experimentation on a large scale. Institutional competition subjects experiments to the market test. Similarly, public trust in government depends on political accountability and participatory democracy and is easier to attain in smaller jurisdictions. In fact, some political scientists (e.g., Robert Dahl) claim that it is impossible to have a functioning democracy in a union of 450 million citizens as diverse as the current EU.[1]

The first lesson, then, is that the case for decentralization is strong, whether it be to municipalities or states within a nation state or to nation states in the EU. Fiscal federalism analysis strongly underpins the subsidiarity principle.

What about the arguments for centralization? Here, we can note that the classical functions assigned to the central level in fiscal federalism are, for the most part, explicitly reserved for the member states in the EU. Thus, the EU does not have a common foreign policy or a common defense, the two prototypes of national public goods. Nor is the EU responsible for income redistribution between EU citizens or stabilization policy, except for monetary policy in EMU member countries.

The reason for this is, of course, that there is no consensus on foreign policy and defense within the EU, as was clearly demonstrated in

[1] Among other things, smaller jurisdictions facilitate direct democracy, which plays an important role in reducing political agency problems. For forceful statements on this point, see Frey and Stutzer (2006) and Mueller (2006).

the disagreement over the Iraq war. Furthermore, most citizens think it too risky to relinquish control over these policy areas. Nor is there the social solidarity across the member states that would justify income redistribution between individuals in different countries. Swedes, for example, are more willing to alleviate poverty among fellow Swedes than among even less well-to-do Greeks or East Europeans. Moreover, Europeans are reluctant to give the EU real taxing power, probably due to the fear that taxes would rise and/or that their own country would be collectively exploited by other member states. Anyway, national policy makers are jealously guarding their right to tax their own citizens.[2]

The second lesson, therefore, is that many of the arguments for centralization do not apply to the EU. The unwillingness to delegate classical federal functions to the EU level underlines that the EU is not a genuine union and that it lacks the unified purpose and identity of a nation state.

What is left for the EU to do? Clearly, it has an important role to play as an economic union and to ensure the working of an unfettered internal market. That is also what current members have unanimously agreed to. It is an important task and it is a task that will bring mutual benefit to its member states.

In addition, it could use its regulatory authority to deal with externalities affecting member states, e.g., in network industries, infrastructure and environmental policy. It is worth noting that not all spill-over effects affect the whole union and union-wide regulation may not be the answer. The Baltic countries, for example, can cooperate around problems affecting the Baltic Sea without involving the whole EU.

It is hard to see that the EU should have a role in correcting fiscal externalities, since the EU does not have any taxing power or any goal regarding benefit levels. (Federal taxes and benefits would, of course, remove the inefficiency.) Externalities created by different tax and benefit levels are problems for the member states. The problems arise because of the mobility of the tax base. Since firms are more mobile than labor, there may be pressure to harmonize corporate taxes and capital taxes. But that would only solve part of the problem, since firms can (and do) also move to outside the EU. Externalities created by different social benefit levels could lead to migration from low to

[2] Persson et al. (1999) analyze how a political economy view alters the classical assignment prescription.

high income countries merely to take advantage of social benefits. This kind of benefit induced migration may become more of a problem as the EU comes to include countries with increasingly diverse income levels. A straightforward solution would be to restrict eligibility to social benefits to each country's citizens.

Tax competition may be a problem if it leads to a race to the bottom. But it may also have positive effects, as the paper notes, if tax levels tend to be too high. To the extent that benefits are commensurate to taxes, we may have Tiebout style sorting of firms and people in accordance with their preferences. What should we conclude?

The paper does not cite much empirical evidence and this is an area where that would have been useful. How important are the different externalities empirically? What evidence is there of fiscal competition in federal states? In a study for the EU, Baldwin and Krugman (2000) concluded that there was no evidence of a race to the bottom or even narrowing of tax differentials across countries as integration in the EU has increased.

The third lesson which I draw is that the EU should focus on its primary task to ensure an internal market. The extent to which it should get involved in correcting for various fiscal externalities is arguable.

The problem the EU faces today is that it is an uncomfortable hybrid with ambitions to become a political union. That was reflected by the proposed constitution for the EU. But even under current rules, more and more decisions which are unrelated to the internal market are becoming centralized to the EU level. This open-ended integration can be unstable, as noted earlier. It may lead to excessive centralization, political conflict and a backlash, which can undo earlier integration gains.

The paper does not address this problem, but other political economists have. The model for flexible integration presented in a CEPR study (Dewatripont, et al., 1996) offers an attractive solution to this dilemma. The model is based on the idea that all EU members accept a common core of EU competency, where decisions are made at the supranational level. The core is defined as those policy areas which are central to the realization of the internal market and which all members unanimously sign on to as EU members.

In addition, groups of member states can form open partnerships where they cooperate in other areas of mutual interest to them. These partnerships are voluntary and open to all those who wish to participate now or in the future. Constitutional constraints limit the EU level to move beyond the core, unless member states unanimously agree. The open partnerships allow countries to integrate further, if they wish to do so. By protecting the common core and by making further integration voluntary, as well as experimental, the model makes the integration process more stable. It should also satisfy the diverse interests of those who want more integration as well as those who want less.

The fourth lesson, from the broader political economy analysis, is that the EU needs constitutional constraints to prevent the integration process from being destabilizing. Flexible integration provides a useful model.

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