Decentralization and Supranationality: The Case of the European Union

by

Pierre Salmon
Université de Bourgogne

November 2000

Contents

I. INTRODUCTION

The European Union and its member countries are experiencing a double movement of centralization and decentralization.[1] Centralization consists of a partial transfer of national decision-making to collective decision-making at the level of the European Union. So far, it has affected all the member countries in a fairly uniform way - with some exceptions such as EMU or Schengen.[2] By contrast, decentralization, which concerns the powers and activities of subnational government, takes forms and has an extent that differ considerably across countries.

The theory of fiscal federalism says much that is useful to improve our understanding of the processes of centralization or decentralization in the European context.[3] The analysis that follows is largely inspired by its insights. However, that analysis is based on an interpretation of governmental systems that departs from the theory of fiscal federalism by putting more weight on competition among governments, both those situated at the same level of jurisdiction (horizontal competition) and those situated at different levels (vertical competition).[4] Even though some issues could be dealt with indifferently under horizontal or vertical competition, the organization of the paper reflects that distinction. Some general characteristics of the two kinds of competition are spelled out in Section II, whereas a discussion of three sets of important issues that have a bearing on horizontal competition in the context of the European Union takes place in Sections IV, V and VI. These issues are the effects on the capacity of governments to compete, first, of a "level-playing field" logic that

---

[1] "Centralization" and "decentralization" can be understood either as processes or as states; "decentralization" is in addition the name of the field or subject and may consequently cover references to all of these processes or states - which, although we will discuss centralization, explains the reference to decentralization only in the title of our paper.

[2] These exceptions may become the rule as an outcome of the currently discussed institutional reform.

[3] See, e.g., Hemming and Spahn (1997).

[4] See Breton (1987, 1996), Salmon (1987, 2000).

purports to eliminate all causes of fragmentation and distortion of competition within the EU internal market, second, of tax-induced mobility and tax competition, which affect what governments can supply, and, third, of the implications of the rules adopted in the wake of EMU to limit in each member country public sector deficits and borrowing. Section VII focuses on vertical competition aspects of the EU considered as a multi-level system. Section VIII is a short conclusion. The very peculiar nature of the European integration project in general is another reason to avoid a mechanical application to the question of decentralization in the European Union of the insights of the theory of fiscal federalism - or, for that matter, of the analysis of competitive government exposed in the next section. Section III is devoted to a stylization of the European Union that is convenient for the analysis that follows and also reflects this peculiar nature.

II. TYPES OF COMPETITION AMONG GOVERNMENTS

As noted above, competition among governments can be referred to as horizontal when it takes place among governments situated on the same level of jurisdiction and as vertical when it opposes governments situated at different levels.

Horizontal competition

In the literature, horizontal competition among governments is generally associated with the interjurisdictional mobility of factors, individuals and firms. At the limit, its effect is to compel governments to equate the taxation of interjurisdictionally mobile factors with the benefits they provide these factors with (Oates and Schwab, 1988). In other words, mobility-based competition does two things: it compels governments to be efficient, and it erodes the tax bases available to them for the purpose of redistribution. Probably all economists like the idea of competition constraining governments to be more efficient. But the profession is divided with regard to the reduced scope for redistribution. Economists who strongly distrust

governments may welcome this prospect whereas those who assume governments to be benevolent may regret it. Most economists, however, stand somewhere in-between.[5] They do not fully trust governments to engage exclusively into "legitimate" redistribution, but they do not like the idea that redistribution and other policies that they do find "legitimate" or "useful" may be precluded as a consequence of mobility-based competition. Thus they will typically advise that competition be somehow either complemented or bounded. The traditional solution in public finance is the intervention of a higher level of government not itself submitted to the same kind of competition. Following Richard Musgrave (1959), redistribution should be assigned to central governments, even if, by the means of various kinds of grants, its implementation may be entrusted to subcentral governments. The problem is that, as a result of globalization, "central governments" are themselves engaged in mobility-based competition. The same logic then leads to the proposal of a world fiscal organization. A variant of this solution, also discussed extensively in the setting of public finance, is "harmonization", that is an agreement among governments located on the same level to limit competition along some dimension, taxation for instance.

Less well known, there is a kind of competition that may be as important as mobility-based competition but does not raise the same problems. It is based on comparisons of performance and can be specified either as a tournament or as yardstick competition. The mechanism (in the case of a tournament) is very simple (Salmon, 1987). A voter in jurisdiction A, in the policy areas she is interested in, compares outcomes (in these areas) as she can observe them in A with what she knows of outcomes (in the same areas) in (to simplify) another jurisdiction B, situated on the same level (e.g., municipal, regional or national). If she considers the relevant outcomes in A to be superior to what they are in B, this will on average increase somewhat the probability that she will vote for the incumbents at the

[5] A position whose theoretical expression can be found, for instance, in Edwards and Keen

next election. If she perceives the performance of her own government in A to be relatively inferior, this will on average reduce somewhat the same probability. Elected office-holders do not know how each voter will vote.[6] They do not even know each voter's priorities, nor what are the jurisdictions that each voter compares with her own. But their awareness of all sorts of comparisons being made by voters and influencing their votes is enough to provide them with an incentive to exert themselves in as many areas as possible.

The policy areas or outcomes that are relevant depend on the level of jurisdiction. They are not the same at the level of municipalities and at that of national governments. In all cases, however, they must be understood as rather inclusive. Are concerned not only the goods and services that the jurisdiction's government provides, but also the taxes and fees that it collects, the rules or regulations that it enacts, and the economic and social conditions it may be responsible for, in terms of aggregates such as income per head, growth, or unemployment. Another important observation is that tournaments or yardstick competition take place in a dynamic setting. Thus perhaps their strongest effect is to induce governments to innovate and to imitate innovations introduced by other governments. Performance competition does not only increase accountability and efficiency, it is also a major source of experimentation and innovation.

Apparently, competition based on comparisons of performance has no disadvantage and is thus in no circumstances likely to inspire the mixed feelings noted above with regard to mobility-based competition (it is perhaps more likely to be received with a touch of scepticism - see Bird, 2000). In fact, this is not exactly true. The source of the problem is that some types of policy outcomes may be much more amenable than others to interjurisdictional

(1996) or Fuest (2000).

[6] Hence the plausibility of the theory of probabilistic voting, which more generally accounts for the fact that politicians try to please all categories of voters, even those whose vote is mainly for their competitors.

comparisons. This creates an incentive for the competitors to concentrate their efforts on these types and sacrifice other worthy policy objectives.

In labor economics and neighbouring fields, there is some work (e.g., Holmstrom and Milgrom, 1991) that addresses exactly that kind of problems. One solution this literature offers is to give up "high-powered" incentives and remain satisfied with "low-powered" ones. In the setting we are concerned with, this suggests that the absence or impossibility of comparison-based horizontal competition among governments may be a good thing in some circumstances. Such impossibility may result from the assignment of the relevant policy area to a multinational authority, or to a body made up of non-elected officials whose career is independent of performance (e.g., the *Conseil d'Etat* in France). Another solution spelled out in the literature is the separation of tasks among different agents. In the setting of competition among governments, it provides a good reason to have many levels of government and try to differentiate the tasks among them. For instance, if national governments compete in terms of some macroeconomic variables, such as economic growth, this may lead them to sacrifice some important social objectives, which suggests that these social objectives might be better served if the responsibility for pursuing them were assigned to lower-level governments competing for relative performance on social policies.

These considerations suggest a rationale for the division of responsibilities among levels that is likely to be different from the one the theory of fiscal federalism is based on. Because the latter, which stresses mobility-based competition, does not cease to be relevant, an interesting albeit difficult question is to what extent the two forms of competition complement or harm each other. The question cannot be addressed in a systematic way in this paper but it will underlie some of the issues discussed below in the context of the EU. Inasmuch as the form of competition we are the most interested in is comparative performance competition, which is largely based on the capacity of governments to innovate, we will see that the

question often arises of whether this form of competition is not hindered by the effects of the other form, that is, competition based on mobility and in particular tax-induced mobility.

Vertical competition

Contrary to horizontal competition, vertical competition cannot be based on mobility. Two other types are conceivable. One involves some rivalry over the same tax base - as when both a central government and a junior government are enabled to tax income and fix independently the rate of the tax.[7]

The other is, again, comparative performance competition. If A is a country and B a region of that country, voters in B compare the performance of B's government with that of A's. If they are pleased with the performance of B's government more than with the performance of A's government, this makes them on average more likely to vote for the incumbents in the next *regional* election and less likely to vote for the incumbents in the next *national* one. This provides elected office-holders with the same kind of incentives as those noted above in the context of performance-based horizontal competition.

For performance-based vertical competition to be possible, it is preferable that the different levels of government do not fulfill completely different and separate functions.[8] It is better if there are some shared attributions - designed as such, or the result of an imperfect and flexible assignment of tasks among levels (as is in fact the case in all governmental systems). Admittedly, there are limits to the positive effects citizens can expect from that flexibility. Pushed too far, a confusion of tasks among levels would increase rather than

[7] In the literature, this kind of competition is often analyzed not as competition but as a negative policy externality, in the same way as mobility-based horizontal competition (or, in particular, tax competition) is analyzed as a positive one.

[8] Preferable but not strictly indispensable. One may find the officials of B generally more diligent or friendly, less corrupted, and so on, than are the officials of A. Even if both groups accomplish completely separate tasks, this observed ranking may make one a little more inclined to vote for the incumbents at the next election in A and a little less inclined to vote for the incumbents at the next election in B.

mitigate the problems that citizens encounter to get what they want from the public sector as a whole.

Without proper arrangements, vertical competition may also be highly unstable. Competition in general suggests some kind of symmetry or equality between the competitors, whereas vertical relations between levels of jurisdiction are typically asymmetric and unequal. This explains that the distinction between merely decentralized and genuinely federal systems becomes relevant mainly in the context of vertical competition. In federal systems, level-two governments enjoy some constitutional protection against the deeds of the central government. In addition, they typically organize as they wish their non-federal relationship with level-three governments. To some extent thus vertical competition between level one and level two is among equals. In systems that are not federal, even when they are decentralized, level-two governments are more like simple agents of the central government. In addition, they typically do not enjoy the right to deal as they wish with level-three governments, which are also more or less like agents of the central government. That distinction is somewhat blurred by the use of discretionary grants and the existence of limits to tax autonomy.

III. THE EUROPEAN UNION STYLIZED

Decentralization in the European Union includes both the question of decentralization within member countries and that of the way responsibilities are distributed or shared between these countries and the European institutions in Brussels, Luxembourg, Strasbourg, or Frankfurt (hereafter "Brussels" tout court). These two questions are not unrelated.[9] To discuss them within a common framework , central and subnational levels of governments in the member countries together with the European level of decision-making will be considered as elements

[9] Thus Bernd Spahn (1997b) writes: "The European Union has emerged as a vehicle for both supranational policies and the devolution of powers to regions" (p.103). One may find the

of one single governmental system, stylized as a four-tier governmental system. At the bottom, so to say, the local or municipal level (level 4) is very, and perhaps increasingly, important in the eyes of citizens. At the same time, in several of the countries, it faces financial difficulties or obstacles to gain or maintain its fiscal autonomy. Between this level and that of the central governments of the member states, it will be convenient to assume one level and refer to it as the "regional level" (level 3).[10] The importance of that level is a central characteristic of the member countries that are federal and is increasing in most others. Still, national differences remain considerable. The level of the countries' central governments (level 2) remains by far the most important, especially with regard to fiscal matters.

The interpretation of decision-making at the level of "Brussels" (level 1) is the most controversial. The European Union is an hybrid, and that in terms of at least two different distinctions - the first mostly used by dispassionate observers from outside Europe, and the second by active, politicized participants in the ongoing debate "on Europe". Belonging to the first category, an interesting paper by Bruce Ackerman (1997) claims the existence of a continuum between international treaties and federal constitutions, and thus between international organizations and federations. It is clear, as Ackerman notes, that the European Community, even before it became the European Union, has moved a long way, along the continuum, towards the latter. This is true mostly with regard to the capacity to legislate or regulate. For some time the main mechanism enhancing that capacity was the remarkable way the European Court of Justice succeeded, together with the (non-constitutional) courts in the member countries, in imposing an interpretation of the Treaty of Rome that implied the supremacy of European law over national law in the vast policy areas covered, directly or

---

statement a bit excessive in the second half of the proposition, but must certainly agree that the two movements are connected.

[10] In reality, this level is missing in Finland and Luxembourg. It is divided in two in Belgium, France, Germany, Ireland, Italy, and Spain. The case of the United Kingdom is more complicated. See DEXIA, 1997.

indirectly, by this Treaty, as well as the "direct effect" of a large subset of European law in legal proceedings in the member countries. This established a hierarchy of laws typical of federal systems (Weatherhill, 1995). Since the Single Act of 1987, the capacity to legislate is also enhanced by a much enlarged room for qualified majority voting in the Council of Ministers. Finally, new regulatory powers on fiscal discipline have been introduced in the wake of the European Monetary Union. The institutions in "Brussels", however, are still far from constituting a federal government. Among the characteristics that make them different from it, the one which is perhaps the most relevant for the purpose of this paper is the very limited amount of financial and human resources they can rely on.

Among participants in the political debate on the future of Europe, the preferred distinction is between "supranational" and "intergovernmental" decision-making. Even though the exact meaning of these terms is not that clear, it is worth stressing and elaborating a little at this stage, firstly, that both kinds of decision-making mechanisms currently play a role in the current arrangements, secondly, that this will remain a central characteristic of the EU in the foreseeable future, and, thirdly, that this is likely to be highly relevant for the questions addressed in the following sections.[11]

Elements of supranationality within the decision-making machinery of "Brussels" are certainly the European Court of Justice, or more generally the hierarchy of laws referred to above, the European Parliament, and, now, the European Central Bank; usually, albeit less compellingly, are also included the Commission, with its bureaucracy, and the use of majority-voting in the Council of Ministers. Elements of intergovernmentalism are the requirement of unanimity-voting in the Council of Ministers in many policy areas and the strategic role of the European Council - a regular "summit" among the heads of government and the president of the Commission. As a consequence of supranationality, there are many

[11] On this topic, see also Ludlow (2000).

things that can legally be imposed on any country against its will, but as a consequence of intergovernmentalism, there are also many decisions that any country can veto if it wishes.

This does not mean, as if often believed, that there is a precise dividing line between two sets of issues, depending on whether they are decidable or not by the means of majority-voting. In a set-up in which the same decision-making institution operates in many issue areas, even if it can have recourse without restriction to majority-voting, there will always be a strong incentive among decision-makers to bargain and engage into trading positions over issues (Cooter, 2000). The fact that, for some types of decisions, majority-voting is unavailable and unanimity required can only strengthen that incentive. The consequence, in the EU context, is that the representative of countries will often accept measures that they do not like and, because they belong to the "unanimity requirement" category, could oppose. Conversely, a qualified majority, even when it is entitled to do so, will typically avoid imposing on a country a solution that its representatives intensely disapproves of (and which they consider as important). This does not imply that the extension of the domain of qualified majority-voting is unimportant. When the representative of a country is opposed to a proposal and obtains that a majority does not impose its adoption even though it could, a cost is incurred, a debt is subscribed which will have to be repaid in the form of a concession in another area or on another occasion. Majority-voting sometimes exerts its power in a straightforward way. On other occasions, decision-making will require complicated bargaining and the reliance on the leadership of some member countries.[12]

The intricate combination of bargaining over several issues simultaneously and of voting, which is thus a fundamental characteristic of current arrangements, is not likely to be clarified in the near future, and even less likely to be replaced by a well-designed "federalist" constitution. The most obvious reason is the well-known divergence of conceptions about

European integration in general among the different countries. But, more fundamentally, keeping in the dark the final aims or destination of European integration, as well as the significance of its major steps, has always been and is likely to remain central to the whole undertaking even in the countries that are the most favorable to it.[13] Supranationality has gone quite far in some areas because it seemed clear that intergovernmentalism was not seriously challenged in principle and remained available in fact if really needed.

In view of the analysis developed in the following sections, the most important point to keep in mind is this availability of intergovernmental decision-making when it is really needed. As noted it offers each country a safeguard with regard to its most basic interests. But it also implies that if a majority is frustrated by the rule of unanimity of a collective decision to which its members give a high priority, it will often be able to overcome that obstacle by the means of exchanges and side-payments. Sometimes the intensity of interests and preferences is symmetrical, and relative power will settle the matter, or the status quo will prevail and there will be talk of a deadlock. Often though that deadlock will be only apparent, and the apparent impotence of the majority reflect or hide half-hearted demands or insincere priorities.

IV. THE EFFECTS OF THE "LEVEL-PLAYING FIELD" LOGIC ON HORIZONTAL COMPETITION

A benefit that one may expect from horizontal competition is that governments experiment and innovate, that is, try to make new services available to citizens or to implement new or more efficient ways to deliver the existing ones - what has been called "laboratory federalism" (Oates, 1999). However, a government that departs from what other governments are doing

[12] For an analysis of leadership in federations and in the context of integration,addressing the question of whether unified Germany was likely to play this role, see Salmon (1992).
[13] In this sense, it is true that European integration is a kind of conspiracy, but not in the way or for the reasons that are usually implied when this term is used. See Salmon (1995).

almost always fragments the economic space.[14] As a side-effect of this difference with others, which reflects its innovativeness, it creates a non-tariff and non-border barrier to trade - implying additional transaction costs for private-sector activities that straddle jurisdictions and rents for those that do not - and/or a distortion. Cases that typically come to mind concern the side-effects of domestic regulations or the distortions of competition among firms brought about by subsidizing some of these firms. We concentrate on these cases here but must note in passing that differences in tax systems or in legal systems across jurisdictions, even though they seem almost essential characteristics of autonomy, are also a source of fragmentation of the economic space and of additional costs for interjurisdictional activities.

Now, what has happened in Europe is the adoption of an increasingly ambitious agenda of elimination of all barriers to trade and distortions of competition. That side-effects of domestic policies are a major target of that program is clear from the emphasis on the elimination of "non-border" barriers to trade, and that subsidies to firms are another equally important target is manifest from the adoption of "fair competition" and a "level-playing field" as criteria for corrective action under the program.

In one way or another, such an endeavor is bound to seriously limit the autonomy of national and subnational governments. It can do so in two ways. Over a long period, things seemed to evolve according to the first. Since the Single Act of 1986, the second seems to dominate. One may encapsulate the difference between the two as coming down to the question of whether the decision-making capacity lost by national and subnational governments mainly goes to the private sector of whether it mainly goes to collective decision-making in Brussels - in other words, whether the main tendency is deregulation or regulation centralization. Ironically, the more ambitious the content given to the objectives of

[14] See Breton and Salmon (forthcoming) for a more elaborate analysis of most of the points made in this section. See also Breton (1996), Mueller (2000), Trebilcock and Howse (2000).

free trade and level-playing field, the more centralization will tend to prevail over deregulation. I elaborate briefly on these points.

The first phase is dominated by the judicial interpretation of the dispositions and legal rank of the Treaty of Rome. The principle of freedom of trade and movement that it institutes is given a constitutional status comparable to that of the Commerce Clause in the United States Constitution (Majone, 1996). At the same time, the capacity to regulate at the European level is hampered by the rule of unanimous decision-making. In this setting, everything depends on the activism of the courts - or of the part the European Commission that plays a role akin to that of the courts. With sufficient activism on their part, many activities of national and subnational governments will be prohibited or curtailed. This process of "negative integration", or "integration by law" thus seemed to give some plausibility to the prospect of a European Union resembling the US economy of the 19th century in the two characteristics that made it successful according to Barry Weingast's "market-preserving federalism" (1993): "the authority to regulate markets... not vested with the highest political government in the hierarchy", and "the lower governments...prevented from using their regulatory authority to erect trade barriers against the goods and services from other political units". However, under a judicial interpretation of trade barriers inclusive of all the side-effects on interjurisdictional trade of the activities of national and subnational governments, Weingast's two requirements implied a down-sizing of government in general that was, given what is expected from it in modern societies, clearly unrealistic in the European context.[15]

In any case, the perspective introduced by the Single Act of 1986 and the 1992 project is completely different. Its two main ingredients are, thanks to greater allowance of majority-voting in the Council of Ministers, a much-enhanced capacity to make laws or regulate at the level of the EU and a renewed emphasis on the achievement of a perfect internal market,

implying the eradication of all barriers to trade and competition distortions.[16] The combined effect of these two ingredients has been an extensive process of harmonization or standardization of regulation. Member-state and subnational governments have been deprived of much of their autonomy in some areas, but the main regulatory capacity has been firmly relocated at the center - not quite the division of responsibilities prescribed by Weingast as a condition for "market-preserving federalism".

The principle of subsidiarity introduced in the Treaty of Maastricht reflects a new concern with the protection of some decision-making capacity at the subcentral levels of government (i.e., national and subnational levels). But, it is not clear that the contradiction between extensive interpretations of subsidiarity and subcentral government autonomy on the one hand, and the single-market and fair-competition agenda on the other hand is as yet fully perceived. Centralization is still widely imputed to the bureaucrats in Brussels, not to the partisans of unfettered markets in London and elsewhere.

The observation of what obtains in federations such as the United States, Canada or Switzerland, however, should convince everyone that fairly unified internal markets are quite compatible with states, provinces and cantons remaining free to implement policies that, as side-effects, generate non-border barriers to trade among them. In similar fashion, both the normative principle that competition must be enforced for the benefit of consumers rather

---

[15] For a persuasive criticism of Weingast's market-preserving federalism, see Rodden and Rose-Ackerman (1997).

[16] The "mutual recognition" principle, as spelled out notably by the European Court of Justice in its famous *Cassis de Dijon* ruling (1979), is also part of the "new approach" adopted in the Single Act. It says that , although the production of a good remains regulated by the government of the jurisdiction where this production takes place, the good can be freely exported to another jurisdiction whatever the regulation applicable to its production in that other jurisdiction. This clearly eliminates one barrier to the free trade of goods. The economic space remains, however, fragmented in the sense that imposed modes of production of the good are different across jurisdictions and this may distort the choice between producing in one jurisdiction or in several. It may for instance protect a local firm from a firm from another jurisdiction opening up in its own jurisdiction. It may also distort the trade of

than for the convenience of competitors (Mueller, 2000), and, again, the observation of practice in existing federations, should be enough to inspire the toleration of subcentral government subsidies to private firms - whether for stabilizing local employment or for other possibly legitimate purposes.[17] These remarks assume that excessive emphasis on limiting the capacity to compete of local governments is the result of some misapprehension or illusion. Another possibility is that it is the consequence of more structural differences between the EU and genuine federations.

V. TAX COMPETITION AND THE EROSION OF GOVERNMENTS' CAPACITY TO COMPETE

As noted previously, the mobility of factors of production, firms and individuals may erode the tax resources available to subcentral governments. It may compel governments to engage in tax competition, that is, in a game in which each government reduces the taxation of mobile tax payers in view of attracting more of them. This may hinder the capacity of governments to act and compete along other dimensions. As also noted previously, most economists do not like the idea of governments being prevented by this mobility to implement policies that they (the economists) find useful - social or redistributive policies for instance. Because, in addition to those policies, government officials also like activities that economists do not find useful, one may expect governments to approve even less than economists of the impediments to their decision-making capacity that mobility brings about. Thus, one may expect them to do something about tax competition. An additional reason for that expectation is, in the case of the EU, that most member countries currently have social-democratic governments.

The reassignment of significant taxation powers to the level of the Union, as would be advisable according to the theory of fiscal federalism, is not on the political agenda, and will

---

intermediate goods. Thus if the objective is a completely unique market, mutual recognition will have to be superseded by full harmonization.

[17] See also Besley and Seabright (1999).

not be on it in the foreseeable future. However, the same is not a priori true of recourse to a close substitute: tax harmonization. In fact, the governments of the EU member countries, as well as the Commission itself, have constantly expressed their interest in the implementation of a EU policy of tax harmonization. We have seen with respect to regulation that member countries, together with the Commission, are not unable to harmonize their policies and limit competition when they want to, even if that implies for instance moving from unanimous to majority voting in the domain concerned. There is, however, almost no tax harmonization in the European Union.[18] This raises an interesting question, almost a puzzle. Given the variety of analyses and considerations that concern tax competition, focusing on that puzzle or pseudo-puzzle offers a kind of shortcut to some of the major issues. The necessarily brief discussion that follows will therefore be organized around the question of why there is no tax harmonization at the level of the EU.

A first possible answer brings together two facts. One is that, in the European Union, decision-making in fiscal matters is still subject to the rule of unanimity. The other is that tax competition, contrary to what is sometimes believed, is not a prisoner's dilemma, that is, a game in which every participant loses in comparison to what would result from the adoption by all of a cooperative strategy (Dehejiya and Genschel, 1999). To simplify the exposition, let us neglect for a while the existence of a government-output counterpart to taxation but assume nonetheless that tax-induced mobility is not perfect (Wildasin, 2000). This allows that, at equilibrium, taxes on mobile taxpayers are unequal across countries - in particular, not equal to zero - and that some countries, typically small countries, obtain more tax resources than they would without tax competition, whereas others, typically large countries, get less. Hence this apparently straightforward explanation of the deadlock over tax harmonization: some member countries profit from tax competition and veto anything that could be done to limit it.

[18] There is a little bit in the areas of VAT, excises, and financial relations within multinational

Actually, this does correspond to the observation that countries like Luxembourg profit from tax competition and thwarts the adoption of various schemes demanded by countries such as Germany or France to limit it.

The main objection to this explanation stems from the nature of decision-making in the European Union as it was interpreted in the Section III. When issues are really important, the argument was, intergovernmentalism dominates, and this whether or not a rule of unanimity applies. At the same time, issues are or can be connected, and positions over them traded. This implies that if a majority intensively wishes something, it usually finds ways (interpretable as side-payments and/or as forms of arm-twisting) to overcome the opposition of a minority. Thus if Germany, Italy, France and most other countries strongly wished that a policy of tax harmonization be implemented at the level of the EU, the opposition of a few countries (even including the United Kingdom) would not be able to block it in spite of unanimity rule. This suggests that the explanation of the absence of tax harmonization should also or perhaps mainly be sought in the calculus of the countries that apparently press for it. In other words, how strong or intense is the interest of the governments of countries such as Germany, France, or Italy in having real tax harmonization at the level of EU?

This brings us to a second answer, which requires reintroducing the assumption that mobility-based competition is not only over taxes but also over benefits, that is, of public sector outputs. Firms deciding about the location of an activity look not only at taxation but also at the supply of public services and infrastructures, the security of transactions, the living conditions offered their personnel, all matters that are, as a rule, positively related to public spending and thus to taxation. Individuals who decide about where they will live reason more or less in the same way. The logic of the Tiebout model, which underlies also the model, cited earlier, of Oates and Schwab, implies that some firms and individuals will choose a

---

firms.

location in which the level of both taxes and public services is high and others will choose locations in which this level low. According to models of perfect mobility such as these, what we should not expect to observe at equilibrium is a positive difference between what mobile tax payers pay and what they receive.

How important is this difference likely to be in the absence of tax-induced mobility? In other words, how much discretionary financial power, or redistribution financial power, gets lost for governments as a result of tax-induced mobility? Clearly a lot, in the opinion of all the authors, like Hans-Werner Sinn (1997; forthcoming), who express the fear that the whole welfare state, typical of the socio-economic systems of the member countries of the EU, will not survive when submitted to unlimited mobility-based tax competition (see e.g. Sinn, 1997; Fitoussi, 2000). However, one feels inclined to doubt this, and even argue that the welfare state is not really endangered - or, if it is, not from that kind of causes but for more intrinsic ones. To support that opinion, one may argue that the true redistribution typically involved in the welfare state, and, more generally, in the government policies of the member countries of the EU, is, and has always been, relatively small. In other words, a large part of all the schemes brought together under the name of welfare state are either financed by those who directly benefit from them, or enter more indirectly into the aggregate benefits that mobile tax payers typically consider before making their decision. The bulk of social insurance, pensions, unemployment benefits, etc., is largely financed directly, or indirectly in the form of lower direct remunerations, by the wages-earners themselves - a fact, incidentally, that allows considerable variation in the social systems of the member countries and explains that such variation does not raise the major problems one might have expected. Less obviously, government outputs such as education, assistance to the poor, housing, cultural policies, etc., may also enter the set of benefits that motivates the decision to move to or remain in a particular place.

Admittedly, this alternative view is supported by little or no empirical evidence, except that, so far, the welfare state is not doing so badly in several of the member countries (France, for instance). In any case, it certainly cannot purport to account completely for the relative passivity of member countries with regard to tax competition. First, it does not deny the existence of an important residual of true redistribution at the heart of the ambitious, apparently redistributive, programs making up the welfare state. Second, it glosses over a number of difficulties raised by tax competition even when the purpose of a policy is not redistributive - with for instance moral hazard leading to "fiscal nomadism", that is, to people moving from one jurisdiction to another at different moments of their life (see Sinn, forthcoming; Le Cacheux, 2000). What the argument does is only to suggest one reason why governments may not find the problem of tax competition as dramatic or pressing as it looks.

The third conceivable answer to our question is perhaps the one that comes to mind in the first place even though it is not as decisive as it seems. It can be summarized as follows: because of globalization, tax harmonization at the level of the European Union would be ineffective. Perhaps there is no setting, short of the whole world, in which tax harmonization would be really effective (see Breton, 1998; Tanzi, 1999). But, in any case, the OECD provides a more appropriate setting than does the EU (as demonstrated by the fact that the main discussions take place in the former). This reasoning mainly concerns the taxation of capital income, financial capital being very mobile and able to move almost costlessly, it seems, to places out of the reach of the EU if tax harmonization is attempted there, and of the member countries of the OECD if this is the setting that is preferred.

This widely-held argument is not as able as it seems to account for inaction at the level of the EU. The reason is that it assumes taxation according to the source principle, which renders possible tax avoidance without residential mobility. According to that principle, a resident in jurisdiction A, owning an asset located in jurisdiction B, pays taxes on the income

generated by this asset, and/or taxes on the value of the asset itself, exclusively to the government of B. This allows the resident in A - perfectly legally and openly (as indicated by the use of the term "tax avoidance") and without having to leave jurisdiction A - to choose, as a location of the asset, a jurisdiction in which the tax is as small as possible.

Now, nothing compels the government of jurisdiction A to accept this system and, in fact, many governments do not.[19] It could unilaterally adopt the residence principle, in which case the same resident in A would have to pay the government of A a tax on the income and/or the value of the asset located in B, in addition - if there is no double taxation agreement between A and B, and if the government of B adopts the source principle- to the tax it pays the government of B. If the tax is smaller in B than it is in A, to profit from that difference, the resident in A would now need either to move out of jurisdiction A or to engage not in tax avoidance but in tax evasion, an illegal and covert activity.

This reasoning can be extended to firms.[20] Profits are either distributed or retained. Distributed earnings can be dealt with as above. Retained earnings are normally reflected in an increase in the value of equities, and can thus be reached by the means either of a capital-gain tax or of a general wealth tax, again ordained by the government of the jurisdiction in which the owners have their residence.

When the residence principle applies, only fraud (tax evasion) and residential mobility account for the erosion of the tax base. However, neither fraud nor residential mobility are costless. In particular, governments have many means at their disposal to make fraud costly. Among these means, a particular powerful one is to compel banks to report certain operations

[19] Thus: "Both countries [Japan and the USA] tax income on a residence basis, which means that corporations and individuals owe tax on their worldwide income, whether earned domestically or abroad. Both countries also allow foreign interest income taxes to be credited against the domestic tax liability to prevent double taxation" (Eijffinger, Huizinga and Lemmen, 1998, p. 312).

to fiscal authorities, or to act in part as agents or representatives of the fiscal authorities and implement certain rules. The US government, for instance, is very active and fairly successful in dissuading its residents to use tax havens abroad to evade taxes that they owe it (the US government) according to the residence principle. Of course, the US government's might allows it to exert on international banking an influence and obtain from it concessions that other governments, acting separately, cannot also hope to obtain. But, this is precisely where a common European Union policy aiming at a broader implementation of the residence principle and a more effective fight against tax evasion on the part of its residents could be effective, as effective at the limit as the policy followed by the USA with regard to its own residents. Furthermore, if such a EU policy existed along the American one, the pressure on the rest of the world - in which most tax havens already are, and in any case would have to be located - could be much strengthened. Again, what looms is the suspicion that the EU member-state governments, whatever they say, do not give a very high priority to this matter, a phenomenon which the "fourth answer" to which we turn now is perhaps the most able to account for.

For this fourth answer, we mainly find inspiration in the empirical work done on tax competition in Switzerland by Lars Feld, Gebhard Kirchgässner, and the late Werner Pommerehne.[21] As stressed by these authors, as well as by David McKay (2000), Switzerland is particularly interesting for a reflection on the EU because it is a very decentralized federal system in which the three levels of government (communes, cantons and the federation) enjoy a large degree of tax autonomy , in which, at least originally, the central government could rely only on indirect taxes - direct taxation on income and wealth being for a long time allowed only at the lower-tiers of government - and in which social and redistribution policies

[20] Corporate income taxes, which there is no space to discuss here, can be given, at least to some degree, the nature of a withholding tax and dealt with, a other witholding taxes, by double taxation agreements.

are to a relatively large degree decided or implemented in a decentralized way.[22] What this empirical work shows is that we can have simultaneously: first, tax competition and significant differences in tax rates across jurisdictions; second, a significant effect on the residential choices of wealthy citizens and the location of firms; third, although a few systemic adjustments have had to be made, no strong tendency toward the erosion of the tax base available for discretionary spending purposes by the two lower tiers of government.

The European Union will not emulate Switzerland. Among the major differences, one must note that the policy implementation of interjurisdictional equity considerations (inspiring fiscal equalization, vertical grants, national minimum standard of quality in the provision of public services and social insurance, etc.) - even though not as important as in most other federations - is a characteristic of the Swiss system that the EU will probably not share for a long time.[23] Redistribution across member countries of the EU is and will remain limited - as we will see, the cohesion and structural funds are motivated mainly by other considerations. What the example of Switzerland shows, however, is that substantial tax-induced mobility is sustainable without reducing dramatically the policy-making capacity and autonomy of the governments that are submitted to it. Some inconvenience exists but not to an extent sufficient for a real mobilization.

There are reasons to think that financial problems raised by mobility may become more serious in the medium term. These reasons are: enlargement, with accession of Eastern European countries, which may induce a large immigration in the richest parts of the EU (Sinn, 1999); English becoming a common second language spoken by almost all in the younger generations, which may eliminate a major obstacle to labor mobility; homogenization of "Euroland", in the wake of the EMU, which may also increase mobility

[21] See Kirchgässner and Pommerehne (1996), Feld (2000), Feld and Kirchgässner (2000).
[22] See Spahn (1997).

and encourage comparisons; and delayed effects first of Schengen and then of the EU "citizenship" included in the Treaty of Maastricht, which gives the citizens of the member countries the right and the enhanced incentives to move to any place in the EU.[24]

However, if the problem were to become really serious, with for instance the welfare state systems really at stake, as suggested by Sinn, it is very likely that the decision-making system of the EU would ensure that it be really dealt with.[25]

VI. EMU-INDUCED CONSTRAINTS ON DEFICITS AND BORROWING

Until the Treaty of Maastricht and the European Monetary Union, member countries were perfectly free to develop public deficits and to accumulate public debt as as they wished, and some of them, Belgium and Italy notably, used that freedom to a degree often considered as excessive. This did not mean that no constraints were imposed by central governments (or, in some cases, by constitutions) on the deficits and borrowing of subcentral government. Finland, France, Portugal and Sweden had no such control but all the other member countries had, of one kind or another (see Ter-Minassian and Craig, 1997). Each country could adopt in this matter the rules that it found best, even with regard to borrowing abroad.

---

[23] This disanalogy between Switzerland and the EU is somewhat glossed over in the nice papers of Kirchgässner and Pommerehne (1996) and, to a lesser extent, of Feld (2000).

[24] In fact, Sinn typically refers to what may happen in the future rather than to what is happening now. He writes for instance (Sinn, forthcoming): "Traditionally, the taxation of capital has been a major source of revenue out of which welfare programmes could be financed. However, there is a risk that this source may, with the passage of time, progressively die out".

[25] There may, however, be something deliberate in the toleration of tax avoidance associated with the absence of a EU policy, for instance concerns with economic growth, saving, the size of the capital stock, etc. Jonas Agell and Mats Persson (2000) conclude as follows their study of tax avoidance in Sweden: "From a public choice perspective tax arbitrage and a highly progressive tax system can be viewed as an ingenious way of reconciling incompatible political ambitions. High marginal tax rates convey the message that politicians care about the less well off, while a generous attitude towards tax avoidance prevents the very same tax system from destroying the incentives of the rich and the highly educated" (p. 22)

The Treaty of Maastricht has changed that situation, at least for the countries that have joined the monetary union. Its provisions have been specified and made more stringent in the Pact for Stability and Growth agreed on in 1997. The Pact specifies under what conditions a country will have the right or may be authorized by the Council of Ministers to exceed the ceiling of 3 per cent of GDP for its public deficit. It also spells out an enforcement mechanism, which includes a mandatory deposit transformable two years later into a fine. Finally, it also prescribes balanced budgets or budgets in surplus in normal times or on average.

A first question is whether these constraints are really necessary from a macroeconomic perspective. The opinion of specialists is divided, but there seems to be a growing consensus that they are not. Given the independence of the European Central Bank (and in particular its submission to a non bail-out rule), the excessive indebtedness of a member state or of a subnational entity is not likely to be inflationary, via monetarization of the debt or otherwise (it was the main fear underlying the Pact), nor, given the fact that financial markets are world markets, to significantly affect in other negative ways the other countries (see Eichengreen and Wyplosz, 1998, for a careful discussion). The demonstration that the Pact, and the limitations included in the Maastricht Treaty itself, are unnecessary is fairly convincing. Still, one may wonder whether the means of control (or interference) provided the collectivity of member countries and the EU institutions over the behavior of any single country may not turn out to be useful in some unforeseeable circumstances (the coming to power of a populist party, for instance).

Whether this is a powerful consideration depends of course on the answer given to a second question, which is whether the fiscal constraints may not be seriously harmful. Again the profession is divided on this question. At a time when member state governments are deprived of their monetary policies, is it not dangerous to limit also, as the Pact does, their

capacity to act by the means of a fiscal policy? How will they face idiosyncratic shocks? This is good question, although the likelihood of these devastating idiosyncratic or asymmetric shocks that everybody talks about is not that obvious in the case of the EU. Again, Barry Eichengreen and Charles Wyplosz discuss carefully the question. As the title of their article suggests, their view is that the Pact is not likely to be more than "a minor nuisance". Their main point is that the Pact embodies a lot of flexibility, not so much because of its dispositions, but mainly because this is the way things work in the EU. Their assessment on this particular issue is in perfect agreement with the more general interpretation given in Sction III above. Thus they write:

> "Our assessment is that enforcement of the pact will be relatively loose, but still tight enough to affect some member states' deficits. EU officials will be reluctant to levy fines and lose goodwill. Member states will be reluctant to incur fines and suffer embarrassment. As in most EU affairs, a negotiated settlement just acceptable to both sides is the likely outcome. EU decision-makers will compromise, allowing the 3% ceiling to be violated. Governments will compromise, eliminating deficits that egregiously violate the Stability Pact. They will modify their fiscal policies just enough to avoid forcing the neighbours to impose fines." (p. 101)

A third set of questions concerns the implications of the Pact for subnational governments and their relationship with national governments. This aspect is perhaps the most interesting, even though there is (or I have found) not enough material as yet to discuss it with a minimum of confidence. How will the various levels of government in a given country decide how to share the amount of deficit available for the country as a whole? This amount is not necessarily equal to 3 per cent of GDP because the Pact includes also a prescription (no deficit or even a little surplus) for normal times and, in case of the deficit exceeding 3 per cent, a treatment that varies with the extent of the excess. Thus a national government will tend to have all the time a kind of target or view about the overall deficit or surplus that it would be reasonable to have. The lower-tier governments are not likely to concern themselves directly with that question. However at any moment of time they share among themselves and

with the national government what comes down to a single budgetary constraint. Thus there may be a common pool problem.

As noted, in many member countries, central governments already had large powers of control over the deficits and/or the amount of debt incurred at the lower levels of government. It is possible that the Stability Pact, in the future if not immediately, will lead to new controls, or forms of control, in the countries that had none or in those in which they were relatively lax. This would reduce the autonomy of subnational governments. Perhaps the main risk then is that national governments might use their enhanced power of control over deficits and borrowing to crowd out the capacity to borrow of the lower-level governments. This would be a serious problem in the countries in which these lower-level governments or jurisdictions are responsible for a large part of public infrastructures and capital formation. It would significantly hamper the capacity of governments at the same level to compete among themselves.

In the case of countries in which, at least for the time being, there is no central control of deficits and borrowing at subnational level, or where there are only general rules which do not constrain these variables in quantitative terms (e.g. the exclusion of some forms of borrowing or of some types of lenders), there is an intellectually challenging indeterminacy about what will happen. From a theoretical point of view, one may think of various games (Stackelberg, cooperative games, sequential bargaining, etc.) that governments can play in such a setting.[26]

[26] For a preliminary reflection along these lines and an application to the case of France, see Guengant and Josselin (1999).

VII VERTICAL COMPETITION IN THE EU MULTI-LEVEL GOVERNMENTAL SYSTEM

Before turning to vertical competition proper, it may be useful to elaborate somewhat on the brief remarks made in Section III on the different levels of government. There, we characterized the set of political authorities in the EU as a four-tier governmental system. There is still an element of anticipation in that characterization but much less than even only a decade ago. The system evolves rapidly away from a situation in which the domination of level 2 - nation-states' governments - was overwhelming almost everywhere (only a little less so in a federal country like Germany). Level 2 remains the most important but it has lost many attributions in favour of the EU level - on which, however, national governments are also active actors. Two current transfers of power are in the area of monetary policy and, to a lesser extent (as we saw) in the area of aggregate fiscal policy. We expressed doubts on the likelihood that anything would happen soon with regard to tax harmonization, and reservations about the degree to which the freedom of governments to attempt original domestic policies has been constrained in the name of an eradication of all barriers to trade and distortions of competition. Several other areas are candidates for upward reassignments of competence. Perhaps the most promising among these areas in the near future is immigration policy. Because of the Schengen agreement, for authorizing temporary entry in the space of the EU, each country is in a sense the agent of all the others, which creates a free riding problem. Although less pressing, this time not because of Schengen but because of the freedom to reside anywhere in the EU, the same issue arises with the awarding of rights to residence. In most cases, transfers of competence will remain partial and result in shared attributions - which facilitates vertical competition and, up to a degree, also horizontal competition.

Because level 2 will remain the major one, and because emphasis was put above on performance-based competition - which includes competition by innovation - it must be stressed that, in spite of the problems discussed in the previous sections, competition among national state governments remains very active. They have lost some of their powers but this is compensated by comparisons having become easier. Citizens of the member countries are more able than in the past to compare what obtains in their own country with what obtains inthe others with regard to unemployment, overall level of taxation, incomes per head and rates of growth, etc., and the governments of member countries do their best to perform - and make known that they perform - as well as, or better than the neighbours along these dimensions.[27]

Admittedly, some aspects of horizontal competition have emerged at the level of the EU itself. Comparisons of the performance of the EU as a whole to that of the United States are not unusual anymore in some areas (unemployment, exchange rates, etc.) and may have some influence on the degrees of satisfaction or of dissatisfaction that people express towards the EU or towards their own national governments. This still embryonic phenomenon, however, is not a serious challenge to the relevance of horizontal competition at the member state level.

Another level on which horizontal competition is, as a rule, extremely active is level 4, that of municipalities, especially the municipalities of large cities. They compete in many dimensions - most of them important to voters or to some influential categories of voters. Thus they compete in terms of amenities, urbanism, transports, cultural facilities, exhibition and conference centers, the attraction of tourists and businessmen, economic activities, and, where they may , levels of taxes and subventions. Competition among municipalities is increasingly less segmented by national borders. Urbanistic innovations (roundabouts,

[27] The recent launching by the German Government of a program of reduction, over several years, of the level of taxation was widely noticed and commented on in France, so much so

pedestrian zones, tramways, etc.) spread across national borders with amazing rapidity. Citizens typically heed what happens in their city and willingly compare it to what they know or have seen of others. In several of the member countries, the mayors of large cities (or their equivalents) are important persons, known and influential nationally. Thus maintaining as much autonomy as possible at that level seems clearly advisable.

Level 3, for the EU as a whole, is very heterogneous. The powers and resources available to governments situated at this level ("regional" government in our stylized account), as well as the tasks they are delegated to effectuate on behalf of the central government, vary considerably across member-countries (and in some cases - not only the case of the United Kingdom - even within a single country). So does the intensity of the level-3 horizontal competition that takes place within each country. This is a major obstacle to the develoment of level-3 competition across national borders. This is also a disincentive to attempt a description of the situation here (especially since comparative quantitative indicators are very misleading to gauge the degree of autonomy of the governments situated at this level). Level 3 will consequently be considered here only inasmuch as what happens on it is fairly directly related to mechanisms operating at the level of and in relation with the EU.

The following seven points concern vertical competition.

1. To understand the centralization trend always present in the EU, one must be aware of an important factor: the existence, since the early days of Jean Monnet, Robert Schuman, etc. of a European integration or construction, or "ever-closer-union", project, whose advancement is always in the back of the mind of the Commission in Brussels, and, behind the Commission, of majorities or influential minorities (of citizens, elites, opinion, etc.) in a majority of the member countries of the EU (Salmon, 1995). Those who support this project will tend to welcome occasions to transfer new responsibilities to the Brussels level. For that

---

that the French government felt literally compelled to follow suit and announce a programme

purpose they will be prone to conclude alliances with various other constituencies, pursuing completely different objectives. Thus, depending on the circumstances, they will ally with groups and politicians mainly concerned with continuing redistribution in favour of farmers, with constituencies anxious to save the welfare state, with large firms concerned with reducing transaction costs, with regional actors thirsty for subsidies, or with the supporters of competitive markets who demand that national public services monopolies be dismantled.[28] There is also an active opposition to that project, although it must be stressed first that the expression "ever closer union" is included in the official documents agreed on by all the governments, and, second, that the politicians and other individuals who oppose increased supranationality often justify their position by the claim that it is too early for it, that public opinion is not ready, that there is no European identity, etc. - which shows that they do not contest at least openly the direction in the absolute.

Other factors of centralization are subsidiary to this main one. This is the case of the natural or predictable expansionism of the bureaucracy of Brussels and activism of the European Court of Justice, or of the logic of the "level-playing field" and ""completion of the internal market" whose centralizing effects we discussed in Section IV, or of the launching of the EMU. None of these factors of centralization would have been left free to exist or to develop their effects as they have if there had been no European construction bias in the background. It is probably true that the establishment of a real federation, with powers constitutionally owned by the two levels of government, and vertical fair competition between the two, would put an end to this centralization bias (see Breton, 1996; Breton, Cassone and Fraschini, 1998). But that would mean that the construction of Europe, helped by the

---

of almost the same magnitude.

[28] The best illustration of what we have in mind here is the Single Act of 1986, agreed on, among others, by Jacques Delors, François Mitterrand and Margaret Thatcher.

centralization bias, has achieved its ends, which in a sense begs the question (see section III and Salmon, 1995).

2. Subsidiarity, introduced in the Treaty of Maastricht, is a welcome signal that limits to some of these tendencies need be kept in mind, but not too much should be expected from it as long as the European Union is not a real federation.[29] With regard to the relation between Brussels and the member states, subsidiarity may have influenced a little the rulings of the European Court of Justice, inspired some acts of restraint on the part of the Commission, and strengthened somewhat the arguments of those who anyway were hostile to new steps in European integration. With regard to decentralization, within member countries, towards subnational government, a process which the principle of subsidiarity prescribes, one must admit that the momentous movements of decentralization or devolution that took place in Belgium and Spain, the more limited ones that took place in Italy and France, or more recently, in the United Kingdom, the devolution in favor of Scotland and Wales, have nothing or almost nothing to do with it.

3. More generally, the intervention of the institutions of Brussels at the level of subnational government has had a modest impact so far, except for a few countries. An important factor, of course, is the relative modesty of the funds available to Brussels, and their dependence on the acquiescence of the member states. Thus the history of EU support to regional development reads largely like a series of side-payments - in the 1980s (the so-called Integrated Mediterranean Programmes), to compensate France, Greece and Italy for the impact of competition by the agriculture of the new member countries, Portugal and Spain; in 1988 (doubling of the budget of the structural funds) to secure the adhesion of the poorer member countries to the Single Market Program; in 1992 (cohesion fund), to get the agreement of Spain and other countries on the Danish opt-outs from the Maastricht Treaty.

[29] See Breton, Cassone and Fraschini (1998), Inman and Rubinfeld (1998).

Still, in 1988, a relatively ambitious policy of intervention via the structural funds was initiated mainly under the influence of Jacques Delors. In the mind of Delors, the purpose was, it seems, to build up the influence of the EU on subnational government and to induce governments at the subnational level to become active participants in the working of the EU (see Hooghe, 1996). This new orientation of EU policy-making has made that the allocation of funds from Brussels to regional projects has become much more autonomous with regard to the regional development programs of the member states. This has effectively induced, among other reasons, many regional governments to establish direct links with Brussels. It has also fostered the organization and strengthening of the regional level in some countries (Greece, Portugal, Ireland, e.g.) that could qualify for support but in which governments at level 3 were inexistent or weak. On the other hand, its impact in countries in which the regional government level was powerful (e.g., Germany, with its Länder), or regional programmes very large (e.g., Italy, with the programs for the Mezzogiorno), has been limited. The programs based on the structural and cohesion funds have been given a less ambitious interpretation on the occasion of two reforms, in 1993 and 1999. According to a recent assessment, these reforms, however, have not led to a renationalization of the distribution of the funds (Suttcliffe, 2000). Delors's strategy could have led to the creation of a fairly strong direct channel of influence between level 1 and level 3, by-passing level 2. This has not happened so far. The creation, in the wake of the EMU, of a consultative assembly, in which both the regional and the municipal governments are represented, in proportions decided by the member states, has had little impact either so far. Things may change, but for the time being, the member countries still organize as they want the relations between levels 2, 3 and 4.

4. In member states that are unitary, the organization of relations between levels 2, 3 and 4 is left to national governments. In the perspective of a vertical competition between the

central government and the two lower levels, this may cause a kind of conflict of interest. A central government (level 2) that is losing this competition may be inclined to deprive its competitors of the resources they need to compete, or may be tempted to recentralize a number of policy areas it conceded them or shared with them. This danger is particularly serious if lower-level governments have little tax autonomy and are very dependent on grants. Still, one must note that there has been substantial decentralization in several unitary member states - e.g., Italy and France - and with the exception of the United Kingdom in the 1980s, nowhere any serious tendency to re-centralize. In some cases, constitutional courts have played a role to protect junior governments (against the infringements of their autonomy by the executive branch of the central government mainly, not, as a rule, against the legislative branch). But more general mechanisms of protection are the monitoring of decentralization by public opinion and the voters themselves, and the power and influence of locally active politicians (Salmon, 2000). The fact that member state governments are themselves engaged in tournaments or yardstick competition can also help to explain that they choose to decentralize some tasks. Thus, decentralization in one country may be imitated in other countries, both because the level of decentralization *per se* may be for voters an object of comparison across countries, and because decentralization may be seen by politicians as a means to improve their comparative performance (across countries again) regarding the policy outputs (education, health, etc.) assessed by voters.

5. In federal, quasi-federal or would-be federal member countries (Germany, Spain, Belgium, Austria, UK in part), the relationship between level-2 and level-3 governments are more like one between equals. This certainly makes vertical competition between levels 2 and 3 much more straightforward. An important question is how level 4 fares in federal systems. In Salmon (2000), it is argued that, ironically, the level of local government may be better protected in unitary states than in federal ones (see also Conseil de l'Europe, 1998, p. 43). As

noted, it is typical of federal arrangements that regions are not themselves federal systems, and that regions are left the responsibility to define the role of cities and organize their relations with them (especially with regard to taxation and grants) without too much interference from the central government. In Germany, in spite of some protection of local government by the federal constitution, this has allowed, for instance, a drastic consolidation of communes to be forced on them by the Länder - an act of authority which, according to Wolf Linder (1994), would not have been possible in Switzerland, whose system is much closer to a real three-level federation. Strangely, attempts at the consolidation of communes have also aborted in a unitary country such as France.

6. More generally, how far can we move in the EU to multi-level federalism? If some day, a three-level federation such as Switzerland became a member of the EU and if the relationship between levels 1 and 2 became more clearly federal, we would have a four-level federation. Does that exist elsewhere? Is it possible? How would it work in a context of vertical competition? Is there an optimal number of levels? These issues have not arisen too much in the theory of fiscal federalism, which does not make a strong distinction between federal arrangements and decentralization. They are necessarily important in theories that stress vertical competition. Very decentralized forms of federalism at all levels seem unlikely. At the limit, if level-3 governments (e.g., of Catalonia, Scotland, etc.) become really very autonomous, this may raise serious problems to the EU system (e.g., how are commitments made in Brussels by level-2 governments bind level-3 governments, a problem that already arises in a mild form, in Germany notably) and lead to a secession of some level-3 regions from level-2 national states, the former regions becoming full member states of the EU.

7. These reflections inspire rather mixed feelings toward the federalization of member countries which are still unitary states (a perspective which is topical only in Italy so far). One consideration already stressed is that, currently, the communal or municipal level is perhaps

the most interesting level of government, and that, possibly, it is better protected against vertical competition when the level responsible for monitoring that vertical competition is that of the national governments rather than when it is the level of regions. Another consideration is that, in the case of a given country, three-level federalism may turn out not to work well. The country might then, in the end, have to decide between federalization upward or federalization downward. This dilemma may also result from another mechanism. For member state governments, both the transfer upward of responsibilities to the EU and the transfer downward of responsibilities to subnational governments are sources of disruption or stress. Each requires the devotion of considerable political resources. In addition, the central bureaucracy in member-state governments loses attributions, prestige, and incentives as a result of both reassignments. Thus, because political resources and the costs that the bureaucracy can bear are both limited, a priority must be defined. Because the centralization process is a common undertaking, a kind of public good, whereas federalizing downward is a kind of private good, there is an externality involved when a country chooses to slow down the process of integration for the purpose of concentrating on its own project. Currently, then, and from the perspective of the collective, there are reasons to give the priority to European construction.

VIII. CONCLUSION

Federalism, or more generally multi-level government, is a way to unify what must be unified and to allow the rest to be as diverse as possible. What should and what need not be unified? The answers that economic reasoning suggests have rarely coincided with those that policy-makers have given in the case of Europe. This has often proved frustrating to economists. One cause of this discrepancy, observable also in other domains, is that economics is not very well at ease, as yet, with the way politicians manage to pursue objectives with which they

themselves, the economists, in fact agree or do not disagree. For example, the main economic effect of the Common Market has been to introduce competition and market forces in systems that it was not politically feasible to liberalize in a wider setting, as many economists recommended. Inducing pacifically or, at the limit, surreptitiously, each year, a large percentage of the poorest, most deserving, farmers to leave the farm, is an achievement of the Common Agricultural Policy, which economics, even public choice economics, is ill-equipped to appreciate. The main cause of the discordance, though, is more specific to characteristics of the European integration process. The paper has emphasized the peculiar characteristics of decision-making in Brussels and the importance of a European construction bias. In combination, these two characteristics - constitutive of "the European method" to the assignment of responsibilities - explain that occasions are seized, as when a Socialist President of the Commission puts all his weight behind a very market-oriented program, that the natural or rational order of things is not adopted, as when the elimination of intra-European border checks precedes the adoption of a common immigration policy, or that ominous but not imminent perspectives remain unheeded, as is the case with regard to the possibility that progressively tax bases vanish and the welfare state be dismantled.

This EU method has proved its worth but has some drawbacks, especially when, as is the case in this paper, under a perspective that emphasizes competition among governments. Because the EU method includes a bias as an essential structural characteristic, it is prone to lead to centralization to a degree that will be deemed excessive if the purpose of the bias, European construction, is not taken into account. The paper includes an examination of three areas in which the question of centralization in favor of the EU institutions arises, together with the question of whether competition and experimentation at the level of member state and subnational governments is affected. With regard to the side-effects of governments' domestic policies that may hinder trade or competition, the argument developed here is that

the EU policy in this area, for the purpose of eliminating all non-border barriers to trade and distortions of competition, may affect negatively the capacity of governments to innovate and compete. In the case of tax competition, the problem is the opposite. The EU is inactive. One form of competition, mobility-based competition, affects negatively another form, performance-based competition. Among the reasons that may explain inaction, the one privileged in the paper is the problems created by tax competition not being for the moment serious enough for action to become compelling. The third case concern the fiscal discipline introduced to accompany EMU. The main conclusion of the discussion is that, given the "European method" referred to above, the fiscal constraints will probably prove inconsequential, except perhaps with regard to the decision-making capacity of government at the subnational level. Finally, with regard to downward decentralization, from the national governments to the subnational governments, the influence of the EU is still relatively limited, which explains the variety of the arrangements adopted by the various member countries. Tentatively, the paper suggests that the upward movement of building up the EU level may be an inducement to move more cautiously in the downward direction.

REFERENCES

Ackerman, Bruce (1997). "The rise of world constitutionalism", *Virginia Law Review* 83, pp. 771-97.

Agell, Jonas & Mats Persson (2000). "Tax arbitrage and labor supply", *Journal of Public Economics* 78, nos 1-2, pp. 3-24.

Besley, Timothy & Paul Seabright (1999). " The effects and policy implications of state aids to industry: An economic analysis", *Economic Policy* 28 (April), pp. 13-53 (incl. discussion).

Bird, Richard M. (2000). "Fiscal decentralization and competitive governments", in Gianluigi Galeotti, Pierre Salmon & Ronald Wintrobe (eds), *Competition and Structure: The Political Economy of Collective Decision-Making: Essays in Honor of Albert Breton*, Cambridge University Press (Cambridge & New York), pp. 129-49.

Breton, Albert (1987). "Towards a theory of competitive federalism", *European Journal of Political Economy* 3, nos 1-2, pp. 263-329.

Breton, Albert (1996). *Competitive Governments: An Economic Theory of Politics and Public Finance*, Cambridge University Press (Cambridge & New York).

Breton, Albert (1998). "Public sector efficiency under incipient globalization", *Rivista di Diritto Finanziario e Scienza delle Finanze* 57, no. 4, pp. 442-57.

Breton, Albert, Alberto Cassone & Angela Fraschini (1998). "Decentralization and subsidiarity: Toward a theoretical reconciliation", *University of Pennsylvania Journal of International Economic Law* 19, no. 1 (Spring), pp. 21-51.

Breton, Albert & Pierre Salmon (forthcoming). "External effects of domestic regulations: Comparing internal and international barriers to trade", *International Review of Law and Economics*.

Cooter, Robert D. (2000). *The Strategic Constitution*. Princeton University Press (Princeton).

Conseil de l'Europe (1998). *La régionalisation et ses conséquences sur l'économie locale* (Communes et Régions d'Europe, no. 64). Editions du Conseil de l'Europe (Strasbourg).

Dehejiya, Vivek H. & Philip Genschel (1999). "Tax competition in the European Union", *Politics & Society* 27, no. 3 (September), pp. 403-30.

DEXIA (1997). *Les finances locales dans les quinze pays de l'Union Européenne.* Dexia (Brussels).

Edwards, J. & M. Keen (1996). "Tax competition and Leviathan", *European Economic Review* 60, pp. 113-34.

Eichengreen, Barry & Charles Wyplosz (1998). "The Stability Pact: more than a minor nuisance?", *Economic Policy* 26 (April), pp. 67-113 (incl. discussion).

Eijffinger, Sylvester C.W., Harry P. Huizinga & J.G. Lemmen (1998). "Short-term and long-term government debt and nonresident interest withholding taxes", *Journal of Public Economics* 68, no. 3 (June), pp. 309-334.

Feld, Lars P. (2000). "Tax competition and income redistribution: An empirical analysis for Switzerland", *Public Choice* 105, nos. 1-2 (October), pp. 125-64.

Feld, Lars P. & Gebhard Kirchgässner (2000). "The impact of corporate and personal income taxes on the location of firms and on employment growth: Some panel evidence for the Swiss cantons", paper presented at the Transatlantic Public Economics Seminar on 'Taxation of Financial Income', Gerzensee (Switzerland), 22-24 May; revised version, July 2000.

Fitoussi, Jean-Paul (ed.) (2000). *Rapport sur l'état de l'Union Euroéenne 2000.* Fayard & Presses de Sciences Po (Paris).

Fuest, Clemens (2000). "The political economy of tax coordination as a bargaining game between bureaucrats and politicians", *Public Choice* 103, nos 3-4 (June), pp. 357-82.

Guengant, Alain & Jean-Michel Josselin (1999). "Monnaie unique européenne et contrainte d'endettement des collectivités locales", *Politiques et Management Public* 17, no. 1 (March), pp. 1-16.

Hemming, Richard & Paul Bernd Spahn (1997). "European integration and the theory of fiscal federalism", in Mario I. Blejer and Teresa Ter-Minassian (eds.), *Macroeconomic Dimensions of Public Finance: Essays in Honor of Vito Tanzi*, Routledge (London and New York), pp.110-128.

Holsmtrom, Bengt & Paul Milgrom (1991). "Multitask principal-agent analyses: Incentive contracts, asset ownership, and job design", *Journal of Law, Economics, and Organization* 7, Special Issue, pp. 24-52.

Hooghe, Liesbet (ed.) (1996). *Cohesion policy and European integration: Building multi-level governance.* Oxford University Press (Oxford & New York).

Inman, Robert P. & Daniel L. Rubinfeld (1998). "Subsidiarity and the European Union", in Peter Newman (ed.), *The New Palgrave Dictionary of Economics and the Law*, Macmillan (London) & Stockton (New York), vol. 3, pp.544-51.

Josselin, Jean-Michel et Alain Marciano (1997). "The paradox of Leviathan: How to develop and contain the future European state?", *European Journal of Law and Economics* 4, pp. 5-21.

Kirchgässner, Gebhard & Werner W. Pommerehne (1996). „Tax harmonization and tax competition in the European Union: Lessons from Switzerland“, *Journal of Public Economics* 60, no. 3 (June), pp. 351-71.

Le Cacheux, Jacques (2000). "Les dangers de la concurrence fiscale et sociale en Europe", unpublished MS (June).

Linder, Wolf (1994). *Swiss democracy: Possible solutions to conflict in multicultural societies*. Macmillan (London) and St. Martin's Press (New York)

Ludlow, Peter (2000). "A debate that makes no sense", *The Financial Times*, 20 October.

Majone, Giandomenico (1996). *Regulating Europe*. Routledge (London & New York).

McKay, David (2000). "Policy legitimacy and institutional design: Comparative lessons for the European Union", *Journal of Common Market Studies* 28, no. 1 (March), pp. 25-44.

Mueller, Dennis C. (2000). "Public subsidies for private firms in a federalist democracy", in Gianluigi Galeotti, Pierre Salmon & Ronald Wintrobe (eds), *Competition and Structure: The Political Economy of Collective Decision-Making: Essays in Honor of Albert Breton*, Cambridge University Press (Cambridge & New York), pp. 339-63.

Musgrave, Richard E. (1959). *The Theory of Public Finance*, McGraw Hill (New York).

Oates, Wallace E. (1999). "An essay on fiscal federalism", *Journal of Economic Literature* 37, no. 3 (September), pp. 1120-49.

Oates, Wallace E. and Robert M. Schwab (1988). "Economic competition among jurisdictions: Efficiency-enhancing or distortion-inducing?", *Journal of Public Economics* 35, pp. 333-54.

Rodden, Jonathan & Susan Rose-Ackerman (1997). "Does federalism preserve markets?", *Virginia Law Review* 83, no. 7 (October), pp. 1521-72.

Salmon, Pierre (1987). "Decentralization as an incentive scheme", *Oxford Review of Economic Policy* 3, no. 2 (Summer), pp. 24-43.

Salmon, Pierre (1992). "Leadership and integration", in Gilles Bertin and André Raynauld (eds), *L'intégration économique en Europe et en Amérique du Nord / Economic integration in Europe and North America*, Editions Clément Juglar (Paris), pp. 367-85.

Salmon, Pierre (1995). "Nations conspiring against themselves: An interpretation of European integration", in Albert Breton, Gianluigi Galeotti, Pierre Salmon & Ronald Wintrobe (eds), *Nationalism and Rationality*, Cambridge University Press (Cambridge & New York), pp. 290-311.

Salmon, Pierre (2000). "Vertical competition in a unitary state", in Gianluigi Galeotti, Pierre Salmon & Ronald Wintrobe (eds), *Competition and Structure: The Political Economy of Collective Decision-Making: Essays in Honor of Albert Breton*, Cambridge University Press (Cambridge & New York),pp. 239-56.

Sinn, Hans-Werner (1997). "The selection principle and market failure in systems competition", *Journal of Public Economics* 66, pp. 247-74.

Sinn, Hans-Werner (1999). "EU enlargement, migration, and lessons from German unification", CESifo Working Paper no. 182 (April).

Sinn, Hans-Werner (forthcoming). "European integration and the future of the welfare state", *Swedish Economic Policy Review*, vol. 5, pp. 113-32.

Spahn, Bernd (1995). "Local taxation: Principles and scope", in Jayanta Roy (ed.), *Macroeconomic Management and Fiscal Decentralization.*, The World Bank (Washington, D.C.), pp. 221-31.

Spahn, Bernd (1997a). "Switzerland", in Teresa Ter-Minasian (ed.), *Fiscal Federalism in Theory and Practice*, International Monetary Fund (Washington D.C.), pp. 324-41.

Spahn, Paul Bernd (1997b). "Intergovernmental transfers in Switzerland and Germany",in Ehtisham Ahmad (ed.), *Financing Decentralized Expenditures: An International Comparison of Grants*, Edward Elgar (Cheltenham, U.K. & Brookfield, U.S.A.), pp. 103-33.

Suttcliffe, John B. (2000). "The 1999 reform of the structural funds regulations: multi-level governance or renationalization?", *Journal of European Public Policy* 7, no. 2 (June), pp. 290-309.

Tanzi, Vito (1999). "Fiscalité et architecture du sytème économique international", *Reflets et Perspectives*, 4th trimester; reprinted in *Problèmes Economiques*, no. 2669 (14 June 2000), pp. 30-32.

Ter-Minassian, Teresa & Jon Craig (1997). "Control of subnational borrowing", in Teresa Ter-Minasian (ed.), *Fiscal Federalism in Theory and Practice*, International Monetary Fund (Washington D.C.), pp. 156-72.

Weingast, Barry R. (1993). "Constitutions as governance structures: The political foundations of secure markets", *Journal of Institutional and Theoretical Economics* 149, no. 1, pp. 286-311.

Wildasin, David E. (2000). "Factor mobility and fiscal policy in the EU: Policy issues and analytical approaches", *Economic Policy* 32 (October), pp. 337-78 (incl. discussion).