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## Managing subsidiarity from an economic point of view: Soft co-ordination and hard rules in European economic policy

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**Managing Subsidiarity from an Economic Point of View**

Soft Co-ordination and Hard Rules in European Economic Policy

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This paper was written during a sabbatical at the Economics Department of the University of York and therefore explains why it is written in English and not in German. I received helpful comments from Wolf-Dieter Berkholz, Katja Borchardt, Oliver Farhauer, Christian von Hirschhausen, Susanne Neheider and Horst Zimmermann.

## **Abstract**

On the European level, a variety of different coordination mechanisms are used in different areas of economic policy. The spectrum ranges from complete centralization as in the case of monetary policy to weak forms of coordination like the so-called open coordination in social policy fields. The paper argues that this picture has to be completed by considering market coordination as a hard form of coordination. Then it analyses the necessary elements to decide on the allocation of powers between Brussels and the member states. First, a society needs to decide what should be organised collectively. This is answered quite differently by the member states of the European Union and thus needs to be taken into consideration especially when asking what powers the European Union should have. The theory of fiscal federalism developed criteria on whether the provision of a public good should be centralized or decentralized. These criteria provide a framework for evaluating the competences at the European level but have to be completed by analyzing the own interests of the different institutions within the European Union.

## **Zusammenfassung**

Auf europäischer Ebene gibt es eine Reihe verschiedener Koordinationsformen für unterschiedliche Bereiche der Wirtschaftspolitik. Das Spektrum reicht von einer vollständigen Zentralisierung im Falle der Geldpolitik bis zu einer schwachen Koordination mithilfe der so genannten Offenen Koordinierung etwa in Bereichen der Sozialpolitik. Der vorliegende Beitrag vervollständigt dieses Bild zunächst durch die explizite Berücksichtigung des Marktmechanismus als harter Form der Koordinierung und entwickelt dann einen Rahmen für eine Entscheidung über die Kompetenzverteilung zwischen der Europäischen Union und den Mitgliedstaaten. An erster Stelle steht hierbei die Frage, welche Rolle der Staat generell einnehmen soll, da dies in den Mitgliedstaaten in vielen Bereichen unterschiedlich beantwortet wird und damit Auswirkungen auf eine mögliche Koordination hat. Die Theorie des Fiskalföderalismus hat Kriterien für die Zuordnung staatlicher Aufgaben auf unterschiedliche Gebietskörperschaftsebenen entwickelt und bietet einen analytischen Rahmen für die Beurteilung, ob ein Politikbereich auf EU-Ebene angesiedelt sein sollte. Ergänzt werden muss dies allerdings durch die Berücksichtigung der Konsequenzen, die sich daraus ergeben, dass die jeweiligen Akteure ihre eigenen Interessen verfolgen.

## **1) What is co-ordination, how much is needed and is there an optimal profile of competence in a European wide setting**

There is no doubt that European integration has changed the economic policy of the individual member states. Monetary policy, fiscal policy, tax policy, agricultural policy, competition policy, environmental policy, employment policy, social policy, health policy to mention just a few examples, led to varying degrees of increasing power on the European level while at the same time the „subsidiarity“ principle is codified as a basic rule in the Maastricht treaty.

However, the future competences of the different European Institutions are strongly debated. Some people argue that the European Commission has expanded its own powers to a large scale and therefore call for a decentralization policy, i.e. bringing the power back to the European citizens and to the local and national governments. However, others argue that we need more European power in certain policy areas, e.g. to combat international terrorism or to face the economic challenges of globalisation. Both strategies are to be seen in the context of reducing public hostility towards the European Union.

Some experts want to reinforce the power of the member states,<sup>1</sup> and are calling for a body surveying of the principle of “subsidiarity“ and thereby avoiding the taking over of more and more functions by Brussels. Such a procedure should help to close the existing “democracy gap” between the citizen in the different European member states and the European institutions. As a result, the power of Brussels would be limited according to the interpretation and application of the

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<sup>1</sup> See Spinant, D., UK to propose “subsidiarity“ watchdog, in: euobserver.com from 22. July 2002. <http://www.euobserver.com/index.phtml?aid=7057&sid=9>, see in this connection however Caesar, R., Eine neue Aufgabenverteilung zwischen EU und Mitgliedstaaten?, in Theurl, E., Thöni, E., Hrsg., Zukunftsperspektiven der Finanzierung öffentlicher Aufgaben, Wien u.a. 2002, p. 29-54.

principle of “subsidiarity“ relating to the European Integration and defined through the individual members.

The position can be additionally justified with reference to a proposal of the Commission on the future of the European economic policy. The idea of the Commission’s proposal is to ask for unanimity instead of a qualified majority voting in the Council of Ministers to refuse proposals on the co-ordination of economic policy prepared by the Commission and its bureaucratic power<sup>2</sup>. Through the implementation of this idea the Commission would be empowered to define the standards of co-ordination in the European economic policy field, as unanimity between all member states in questions of co-ordination is unlikely.

But it is not only the Commission and the Council of Ministers who want to concentrate more decision-making powers on central levels of Governance in Brussels; sometimes one of the member states itself prefers more centralization of power. France for example is occasionally asking for a “gouvernement économique”, i.e. a sort of European power in questions of European wide economic policy in addition to what is already done from and in Brussels. Furthermore, France proposed a business cycle fund as a prerequisite for an anti-cyclical fiscal policy.<sup>3</sup> Moreover, the co-ordination of Employment and Social Policy points at the same time in the direction of more central competence with the Commission and the Council of Ministers in Brussels.<sup>4</sup> Furthermore European social policy has become an item of contention as well. “On the one hand, a social policy framed by the European Union is feared to pose a threat to

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<sup>2</sup> Bundesministerium der Finanzen, Verstärkte Koordinierung der antizyklischen Finanzpolitik in Europa?, Stellungnahme des Wissenschaftlichen Beirats beim Bundesministerium der Finanzen, Monatsbericht des BMF, August 2002

<sup>3</sup> See in detail: Tomann, H., Europäische Integration und Wandel des wirtschaftspolitischen Regimes, in: Jahrbuch für Wirtschaftsgeschichte: Wirtschaftspolitik nach dem Ende der Bretton-Woods-Ära, München 2002, p. 62.

<sup>4</sup> See in detail Trubek, D.M., Mosher, J.S., New Governance, EU Employment Policy, and the European Social Model and the Commissions White Paper on Governance, manuscript 2001.

national social and labour market policies; on the other, the absence of the Union's clearly defined competences in this field is held responsible for the citizen's lacking identification with the Community".<sup>5</sup>

Bearing in mind the pros and cons of giving more power to Brussels compared to the loss of sovereignty in the member states it can be clearly said that there is need for a solution settling most of the above questions better than the status quo does. Part of this status are the existing different forms of co-ordination in the different areas of economic policy.

Nevertheless, there already exists a European monetary policy closely linked to the pact on Stability and Growth with its Maastricht criteria. Given the European Law until then this is the hardest form of co-ordination known since 1992.<sup>6</sup> The successful monetary integration with its priority setting in favour of only one of the major goals of monetary policy, administered through the independent European Central Bank, has given an important example of how new institutions may deepen the economic integration of Europe.<sup>7</sup>

More Maastricht-type criteria could emerge as a creeping consequence of the so-called open method of co-ordination in economic policy with all its planned and already established bench-marking systems, resulting in best-practices within the many fields of economic policy all over Europe.<sup>8</sup> The key question now arises: "Do we need more Maastricht-type criteria", is soft co-ordination within

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<sup>5</sup> Maydell, B. v. et al., *Enabling Social Europe*, Berlin 2006, S. IX.

<sup>6</sup> See: Art. 121 (EC) Treaty of Amsterdam (former article 109 j (EC) Treaty of Maastricht, furthermore: European Council, Resolution of the European Council on the Stability and Growth Pact Amsterdam 17. June 1997 and Council Regulation (EC) No. 1466/97 and No. 1467/ of 7 July 1997.; as well: Ohr, R., Schmidt, A., *Europäische Geld- und Währungspolitik: Konsequenzen der gemeinsamen Währung*, in: Ohr, R., Theurl, T., (Hrsg.) *Kompendium Europäische Wirtschaftspolitik*, München 2001, p. 417-466.

<sup>7</sup> See in this connection in Tomann, H., *Europäische Integration und Wandel des wirtschaftspolitischen Regimes*, in: *Jahrbuch für Wirtschaftsgeschichte: Wirtschaftspolitik nach dem Ende der Bretton-Woods-Ära*, München 2002, p. 49-64. He shows how the Single Market Programme together with the European Monetary Union provides the conditions for price stability and competitiveness of the market system codified in the Treaty.

<sup>8</sup> See the contribution on the open method of co-ordination in this volume.

other areas of economic policy enough or do we not need further co-ordination at all?<sup>9</sup>

Within the different areas of economic policy exist

- (a) a single European policy as in the case of monetary policy (including the exchange rate),
- (b) a close co-ordination in budgetary policy with treaty rules in regard to the size of public debt, in combination with commonly agreed rules and objectives, an exchange of information and peer review and more over,
- (c) a weak co-ordination in the field of labour market policies (including wage developments, pensions systems<sup>10</sup>) and product and capital market policies. In the area of weak co-ordination we find again peer review, guide-lines, methods of best practices, agreement on a common understanding, information exchange or just a dialogue. Finally, there are the newly developed
- (d) open methods of co-ordination considered by many as a governance innovation although it comprises the above mentioned forms of co-ordination, mainly the discussion of best practices and peer reviews.<sup>11</sup> It remains an unanswered question whether this will lead to sanctions by the Commission in the future.

Furthermore, European Law as well reflects different degrees of obligation. It exists a close co-ordination regarding the primary sources of the European Law,

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<sup>9</sup> De la Porte, C., The soft open method of co-ordination in social protection, in: European Trade Union Yearbook 2001, Brussels 2001, p. 339-363; furthermore: Dermot, H, Imelda, M., The Open Method as a new mode of governance: The case of soft economic policy co-ordination, in: Journal of Common Market Studies, Vol. 39 (4), 2001, p. 719-746.

<sup>10</sup> Bundesministerium der Finanzen, Verstärkte Koordinierung der antizyklischen Finanzpolitik in Europa? Gutachten erstattet vom Wissenschaftlichen Beirat beim Bundesministerium der Finanzen, Monatsbericht des BMF, August 2002 .

<sup>11</sup> Gesellschaft für Versicherungswissenschaften und –gestaltung e.V. (GVG): Die Methode der „offenen Koordinierung“ in der Europäischen Sozial- und Gesundheitspolitik: Prozessgesteuerte Konvergenz der Sozialsysteme durch Vereinbarung gemeinsamer Ziele und Indikatoren, Informationsdienst 281, Köln 2001.



as there are the treaties, including protocols and the secondary sources defined through article 249 Amsterdam Treaty, meaning regulations, directives, judgements, recommendations and statements/comments. The most binding rules are the regulations, defining on general and abstract basis rules, which are directly binding for all member states, whereas directives are only binding in regard to goals, but open in terms of means.

Apart from the different forms of co-ordination the actors involved have to be taken into consideration. It makes a difference whether the co-ordination is preceded by the Council of Ministers, takes place in joint fora or is implemented by the Commission itself. However, independent of the forms of economic policy co-ordination, its actors and the way of implementation are profound questions to be dealt with:

- Is there an optimal degree of decentralised and centralised competences?
- Does a rational profile and division of power between Brussels and the National Governments exist?
- Does such a profile comprise a better balance between the danger of over-legislation undertaken by the Commission and the Council of Ministers on the one hand and the danger, that local matters that need to be tackled Europe-wide or even need global attention on the other hand, are not adequately recognized?

These questions are easily written down, but difficult to answer. This paper intends to develop a framework of the co-ordination issue from an economic perspective. Certainly, from a legal point of view, from a political science perspective, and on the basis of historical findings one must choose a multi-disciplinary approach before giving advice to the policy makers on an optimised

balance of power in a European-wide setting. Nevertheless, the economic approach is perhaps leading the way as it did so often in the process of the European integration.

## **2) The market as a form of hard co-ordination**

As an initial point, it will be necessary to define the given economic policy framework of a member state, before starting the debate on responsibilities for economic policy and investigating on which level of government the responsibility should be allocated.

A practical perspective stems from the status quo of private and public goods provision in different member states of the European Union. This point of view refers to the different legal frameworks under which the economies work in each country. For cultural, historical, political and other reasons (sociologists call it path dependencies) activities are in some countries organized privately through the market, whilst in others or in other periods of time the same goods are provided publicly resp. collectively. As a third way between parliament and markets a corporatist framework is conceivable, e.g. the self-governmental processes within the different branches of the German social security system. These and other non-governmental organisations belong to the governance structure in question.<sup>12</sup>

Table 1 shows the size of the public sector in different member states and additionally of Japan and the USA, over a certain period of time. Depending on

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<sup>12</sup> see Zimmermann, H., Henke, K.-D., Finanzwissenschaft: Eine Einführung in die Lehre von der öffentlichen Finanzwirtschaft, 9. Auflage, München 2005, p.159 ff.; furthermore Henke, K.-D., Schuppert, G.F.: Rechtliche und finanzwissenschaftliche Probleme der Neuordnung der Finanzbeziehungen von Bund und Ländern im vereinten Deutschland, Baden-Baden, 1993, p. 55 ff. and Monopolkommission, Netzwettbewerb durch Regulierung. 14. Hauptgutachten der Monopolkommission, Bonn 2002 for the importance of cooperatism in other areas than social security.

the base year in many cases the public sector grew. But this picture also shows that there is always a potential to change the magnitude in both directions.

Table 1: The size of the public sector in EU member states, US and Japan 1970, 1980, 1990, 2000 and 2004, as a percentage of nominal GDP

	1970	1980	1990	2000	2004
Austria	38,0	47,1	51,6	51,4	49,9
Belgium	39,7	56,6	53,4	49,3	49,2
Czech Republic	-	-	-	42,1	46,1
Denmark	-	-	57,0	54,9	55,6
Finland	28,2	35,8	48,7	49,1	50,5
France	37,9	45,6	50,7	52,5	54,5
Germany <sup>a</sup>	37,2	46,5	44,5	45,7	47,8
Greece	-	34,5	50,2	52,1	49,8
Hungary	-	-	-	47,8	51,3
Ireland	-	-	43,2	32,0	33,9
Italy	32,7	41,8	54,4	46,9	48,7
Luxembourg	-	-	43,2	38,7	45,3
Netherlands <sup>b</sup>	37,0	50,9	54,8	45,3	48,9
Poland	-	-	-	44,9	47,7
Portugal	19,5	23,2	42,1	45,2	48,0
Slovak Republic	-	-	-	59,5	39,2
Spain	20,5	29,9	43,4	40,0	41,0
Sweden	42,0	57,4	63,5	57,3	57,5
United Kingdom	-	43,0	42,2	37,5	44,4
United States <sup>c</sup>	29,6	31,3	37,0	34,0	35,6
Japan <sup>d</sup>	19,0	32,0	31,7	38,2	36,7

*Note:* Total outlays are defined as current outlays plus net capital outlays. Data refer to the general government sector, which is a consolidation of accounts for the central, state and local governments plus social security. One-off revenues from the sale of mobile telephone licenses are recorded as negative capital outlays. See OECD Economic Outlook Sources and Methods (<http://www.oecd.org/eco/sources-and-methods>).

- a)* The 1995 outlays are net of the debt taken on this year from the Inherited Debt funds.
- b)* The 1995 outlays would be 4.9 percentage points of GDP higher if capital transfers to social rental companies were taken into account.
- c)* These data include outlays net of operating surpluses of public enterprises.
- d)* The 1998 outlays would be 5.4 percentage points of GDP higher if account were taken of the assumption by the central government of the debt of the Japan Railway Settlement Corporation and the

National Forest Special Account. The 2000 outlays include capital transfers to the Deposit Insurance Company.

Source: Years 1970/1980: OECD, Economic Outlook, No. 67, June 2000.

Years 1990/2000/2004: OECD, Economic Outlook, No. 76, December 2004, p.191.

Comparing the members of the European Union in more detail on the basis of table 1 one would recognize considerable differences. In some countries, for example, education or health care are exclusively provided by public institutions. In a few countries, the idea of a private hospital is considered to be unethical, whilst in others it is proven that these hospitals, although they are making profits, do better in terms of patient care and handle cost more efficiently. Thus, the given variety is great and therefore the political options as well. Actually, the figures in table 1 could be adjusted for the possibilities of privatisation or for the different status of property rights in the countries compared.

Should the status quo mixture of public and private goods in the member states be accepted and taken for granted? Until recently, the description of the differing status quo of the legal framework in the individual European member states was taken for granted. But since the treaty of Maastricht (1992) and within the community law there is now clarity, at least from an economic point of view, concerning the character of our mixed economies under European law. Paragraph 81 and the following paragraphs in the Treaty define a clear legal framework with regard to the role of the market economy.<sup>13</sup> This is done for the common market in combination with the four European Fundamental Freedoms of the Single Market, as there are: Free movement of goods, free movement of persons, free movement of services and free movement of capital.<sup>14</sup> On this basis which includes the European competition law, now exists a clear

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<sup>13</sup> See Abbott, K.W., Snidal, D., Hard and Soft Law in International Governance, in: International Organization, 54, 2000, p. 421 ff.

<sup>14</sup> See in detail: Bundesministerium der Finanzen, Freizügigkeit und soziale Sicherung in Europa, Gutachten erstattet vom Wissenschaftlichen Beirat beim Bundesministerium der Finanzen, Heft 69, Berlin 2000.

fundamental framework and analytical foundation for the future of economic policy in Europe and its co-ordination.

By comparing the given legal framework of the EU with the constitutional law e.g. in Germany it becomes clear that the market economy is more codified on the European level than for Germany as one of its member countries. In other countries the situation will be similar and should be put on the agenda of researchers and politicians. With respect to the "subsidiarity" principle this implies that whenever a market can handle the provision of goods, the legal framework in the specific country has to be adjusted to this desire of the founders of the Maastricht treaty and the accomplishment of the Single European Market. A member state ignoring that circumstance can be sued by the European Commissioner for competition.

If this regulatory policy (Ordnungspolitik) is considered to be valid as the basis for economic policy, it comes first to analyse not only possible market failures but in particular government failure and that of politicians themselves, an area where there is no sanction, except elections, like those from competition on functioning markets. Subsequently, from this basis of deregulating where the market forces are the major form of co-ordination, one can proceed to search for other necessary forms of co-ordination. To make the idea more applicable: the forms of co-ordination should always include the question whether there is a potential of deregulation in the concerned area before other forms of coordination are discussed.<sup>15</sup>

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<sup>15</sup> A very sensible example is the National Health Service in the United Kingdom. A shift from direct to indirect control is asked for. What it means is that NHS should be removed from government control and what this means is probably said by Sir Anthony Grabham, the current (2002/3) President of the British Medical Association, who is asking for a radical substitution of the currently tax-financed system by a system that is financed by social security contributions and/or premiums and on a micro-economic basis the management of the patient by private companies under strict supervision of the public. See in this context also Mossialos, E., McKee M., Palm, W., Karl, B., Marhold, F., The influence of EU law on the social character of health care systems in the European Union, Brussels, Observatoire Social Européen, 2001, [www.ose.be/health/filges/corereport.pdf](http://www.ose.be/health/filges/corereport.pdf) (Accessed 16 April 2002).

To sum up: Before starting to argue upon the different ways of hard, soft and the open method of co-ordination it should be verified if an issue is regulated that could be better achieved through the markets and with more distance to political interference. The market economy offers a form of hard co-ordination through competition rules and gives at the same time a good example for the application of the “subsidiarity“ principle as well. Indeed, the market economy is perhaps the most important principle of co-ordination, but is seldom mentioned when the European Commission talks about strengthening the co-ordination in European economic policy. And there are good reasons for this behaviour.

### **3. What does the theory of bureaucracy tell us?**

Having successfully established the Single European Market the European Commission may expect two forces which will strengthen its political powers. Both developments are well explained by economic theory.

One force is represented by national pressure groups in the member states which are faced with the loss of national economic protection. Consequently, they will call for a European substitute of protection and this has to be implemented by the European Commission. This is often neglected as a driving force strengthening the power of the Commission.

It seems contradictory that the member states agree at the same time to the loss of national sovereignty. But economic theory tells us about the gains in terms of maximizing their votes, when policymakers avoid political competition, unpopular decisions, and parliamentary control. If political decisions are transferred to supranational organizations, the political responsibilities are divided or partly removed from competition, majority, and control. In the case of the European Union it is possible that the national legislator has to accept a

European regulation which has been decided at the European level by all national executives.

It is obvious that the European Commission, the European Parliament, and even the European Court of Justice are highly interested in the transfer of political power from the national to the European level. We know from the theory of bureaucracy and the popular Parkinsons's Law about the determinants that let organizations grow. Basically, it is the principal-agent problem which allows them (being the agent) to maximise the budget (paid for by the principal) and finally their own utility.

To sum up: as we have seen before, the economic integration of markets is well controlled by competition. The political integration of institutions which joins the economic integration may lack any analogous control. Instead, the European Union faces a lack of democratic rules and therefore seems to violate the subsidiarity principle.<sup>16</sup>

#### **4) The importance of the theory of public goods and the theory of fiscal federalism**

Before asking what level of government should accomplish a certain public function, and whether the public goods should be provided on a local level, on a regional or on a national basis, on the European level or even a world wide basis, it has to be defined whether the goods that are at present provided should be public at all, and if so, whether they are European-wide goods. Otherwise, the given status quo with its historically grown bundle of public goods has to be accepted. With the acceptance of the status quo as the basis for co-ordination,

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<sup>16</sup> See in more detail Vaubel, R., Europa-Chauvinismus. Der Hochmut der Institutionen, München 2001, p 117 ff and Downs, A., An Economic Theory of Democracy, New York, 1957, Schumpeter, J.A., Capitalism, Socialism and Democracy, new York, 1942 and Niskanen, W.A., Bureaucracy and representative government, Chicago 1971.

however one might risk to co-ordinate things that do not belong together and to implicitly strengthen the Brussels position. Furthermore, the theory of public goods cannot provide valid information about the optimal mixture between public and private goods and finally, it cannot be derived from this theory, whether the public sector in a country is disproportional, meaning too small or too large. More precisely, from a very fundamental position one could try to measure if the public sector has reached already socialism in the sense of too many public institutions, enterprises and expenditures or is still working under the condition of a free market economy. Technically spoken, a clear concept of privatisation and de- or re-regulation of and within the public sector is missing. A solid government supervision is needed. The prerequisite for more private goods and de-regulation is a clear legal framework and at the same time the setting of financial incentives for all participants. This would be the type of co-ordination that makes up the constitutional element of the market economy.<sup>17</sup>

Applying the economic theory of fiscal federalism to the allocation of expenditures and taxes<sup>18</sup> with its internal co-ordination mechanisms means that this regulatory framework of a country is set, i.e. we accept insofar the given quantities of public goods without examining whether the public sector in a particular country is optimally sized in volume and/or structure. On this basis, which is not satisfactory at all, it has to be stated which level of government should be in charge and therefore responsible for the provision and financing of these given “public” goods.

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<sup>17</sup> See in detail Buchanan, J.M., Musgrave, R. A.: *Public Finance and Public Choice: Two contrasting Visions of the State*, Cambridge Mass., 1999, p. 11 ff.; Eucken, W., *Grundsätze der Wirtschaftspolitik*, Stuttgart 1990.

<sup>18</sup> See: Oates, W., *The theory of public finance in a federal system*, in: *Canadian Journal of Economics*, 1, 1968, p. 37 -54.; Oates, W., *On local finance and the Tiebout-Modell*, in: *American Economic Review*, 71, 1981, p. 93-97.; Tiebout, C.M., *A pure theory of local expenditures*, in: *Journal of Political Economy*, 64, 1956, p. 416-424.; Olson, M., *Towards a more general theory of governmental structure*, in: *American Economic Review*, 76, 1986, p. 120 ff.; Olson, M. Jr., *The Principle of “Fiscal Equivalence”: The Division of Responsibilities Among Different Levels of Government*, in: *American Economic Journal*, 59, 1969, p. 479-512.; Zimmermann, H., Henke, K.-D., *Finanzwissenschaft. Eine Einführung in die Lehre von der öffentlichen Finanzwirtschaft*, 9. Auflage, München 2005, p. 191 ff.



To decide upon these issues, the regional or geographical scope of these goods has to be analysed and differentiated between local, regional, national and European wide goods. On the basis of allocation, distribution, short-term and long-term stability, as three fields of interest in public finance, it is possible to develop criteria that help to decide whether certain public goods should be provided more at a central or more at a regional or local level.

Table 2: Criteria for allocating functions to central or decentral government level

Economic objectives	Decision on centralization	Achievement of objectives rather central	Achievement of objectives rather decentral
<b>Efficient allocation</b> public supply adapted to individual preferences			
- principle of fiscal equivalence - principle of "subsidiarity" - provision for regional "spillovers"		(X)	X
b Promoting innovations in the public sector			X
c production at lowest possible costs (provision for economies of scale and divisibility of public goods)		X	X
<b>Distributive justice</b>		X	X
<b>Stabilizing the business cycle</b>		X	
<b>Fostering economic growth</b>		X	(X)

Source: translated from Zimmermann, H. and Henke, K.-D., Finanzwissenschaft. Eine Einführung in die Lehre von der öffentlichen Finanzwirtschaft, 9. Auflage, München 2005, p. 195.

From Table 2 one may extract the different criteria in a more or less operationalised form for purposes of an efficient allocation of resources, a desirable distribution of income and wealth, a stable business cycle and a steady growth.

Unfortunately, this economic approach gives only a very first hint whether a good is considered to be regional or central. And world wide goods would require a world government because their external effects cannot be internalised on a regional level. The distinction between the objectives of allocation, stability and distribution can help to explain and to justify the principle of “subsidiarity“. According to table 2 this principle seems to be seen more within the allocation branch than in the branches of distribution, growth and fiscal policy.

If the spatial dimension of a given public activity (employment policy or health policy) is to be determined, it is not without problems to allocate the responsibility accordingly. In a well defined field of interest, e.g. foreign policy or climate (environmental) policy, central responsibility will be adequate from an economic point of view. However, in most cases, the “subsidiarity” principle must be used in order to avoid the same errors at different places. A quarrelsome example would be the structural policy for specific spatial goals. The situation of a region with its needs must be recognized as well as a base of a successfully applied policy as a European wide view of regional problems<sup>19</sup>.

In terms of identifying an optimal mixture of private and public goods and an optimal profile of governmental competence neither the theory of public goods nor the theory of fiscal federalism are well defined or un-ambiguous.<sup>20</sup> Whether goods are local, regional, national, European- or world-wide depends a lot on

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<sup>19</sup> See more details on structural problems the contribution from Susanne Neheider in this volume.

<sup>20</sup> See: Persson, T., Roland, G., Tabellini, G., The Theory of Fiscal Federalism: What Does It mean for Europe?, in: Siebert, H., Hrsg., Quo vadis Europe, Tübingen 1997, S: 23-41.

the administrative status quo, i.e. the different sorts of federalism in the individual states. In France there are départements, régions and communes, in Germany there are states (“Länder”) and municipalities (“Gemeinden”, “Regierungsbezirke” und “Landkreise”) and in the United Kingdom there are counties and burroughs. To change the boundaries of these political regions according to the principle of fiscal equivalence is challenging and yet recommended throughout.<sup>21</sup>

The EUREGIOS on the borders between European States prove this favourable co-operation between regions and are financially supported through INTERREG means by the European Budget<sup>22</sup>. Certain functions can be fulfilled better with other regional boundaries as the existing ones. What is true for Europe as a whole may be valid for other individual member states as well. An optimal geographical size for the accomplishment of governmental functions is difficult to define but a prerequisite for more fiscal equivalence, i.e. for a better allocation of resources.<sup>23</sup> That principle is an important guideline for organising intergovernmental fiscal relations in a nation and in Europe as a whole.

However, whilst internalising external regional effects provides cost-consciousness, government functions have more elements than just providing and financing a good.<sup>24</sup> It comprises also

- the planning process,

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<sup>21</sup> See: Zimmermann, H., Henke, K.-D., Finanzwissenschaft: Eine Einführung in die Lehre von der öffentlichen Finanzwirtschaft, 9. Auflage, München 2005, p. 194 ff.

<sup>22</sup> See in detail: Schaub, V.E., Grenzüberschreitende Gesundheitsversorgung in der Europäischen Union. Die gesetzlichen Gesundheitssystem im Wettbewerb, Baden-Baden 2001, p. 79 ff.; furthermore Europäischer Sozialer Raum und Gesundheit 1999: Europäischer Sozialer Raum und Gesundheit: Interreg II, Abschlussbericht zum „Grenzüberschreitenden Projekt in der Euregio Maas.Rhein“, Brüssel 1999.

<sup>23</sup> For Functional Overlapping Competing Jurisdictions (FOCI) see Frey, Bruno S., Ein neuer Föderalismus für Europa: die Idee der FOCJ, Tübingen 1997, p 87 ff.

<sup>24</sup> See in this connection the optimum currency area as a completely different example. See Mundell, R.A., A Theory of Optimum Currency Areas, in American Economic Review 51, 1961, p. 657-664. and Tomann, H., Is Europe an optimum currency area?, Birmingham University, Institute for German Studies, German studies 97, 1997 and in connection with tax-policy see Göpfahrt, D., Die Besteuerung multinationaler Unternehmen aus europäischer Perspektive, Baden-Baden 2001.

- the decision process,
- the implementation process and
- the final control mechanism.

These different processes could be and are in reality allocated to different levels of government (co-operative federalism), so that there is a broad profile of competence where levels of centralised and decentralised government are included at the same time within the same field of economic policy. Perhaps, the term governance is used or misused so often to hide the problems behind the various dimensions that are connected with the notion of a public good and its allocation on different governmental levels.<sup>25</sup>

What is missing furthermore in this discussion about the economics of fiscal federalism and the allocation of public functions to different levels of government is a solid empirical basis to evaluate and compare the different approaches to solve the intergovernmental fiscal relations within Europe and on a national basis as well. All member states differ in their systems to allocate functions and responsibilities to their different levels of administration. Therefore, one day a European framework is asked for a solution that solves the problems on the basis of the Single Market with its four freedoms and the European competition law. Part of this desired framework is on the one hand competition between different systems in the Status Quo and on the other hand a financial framework that may lead to a new type of European budget autonomy. Whether this financial constitution includes transferring taxing power or just a financial framework from the member states to Brussels as in the past is to be discussed and has to do with some kind of new cooperative federalism and

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<sup>25</sup> In more detail this problem is dealt with in Henke, K.-D., *Dezentralisierung im Gesundheitswesen - Förderalismustheoretische und empirische Ansätze zur Messung der Zentralität*, in: Henke, K.-D., Reinhardt, U. (Hrsg.), *Steuerung im Gesundheitswesen*, Robert-Bosch-Stiftung (Hrsg.), *Beiträge zur Gesundheitsökonomie*, Bd. 4, Gerlingen 1983, p. 13 – 56 and Commission of the European Communities, *European Governance*, A White Paper, COM (2001) 428 final.

the principle of fiscal equivalence in Europe.<sup>26</sup> What can be said in any case is that financial resources have to go together with the necessity to accomplish certain functions, saying that the revenues have to be determined by the functions (principle of connectivity). Otherwise there is no allocation efficiency to be accomplished.

### **5) A desirable kind of budget co-ordination**

For some people “creeping federalism” describes the danger that the Commission and the Council of Ministers claim more and more power for Brussels and at the same time cause a growing democracy gap between the EU and its citizens. As long as the Commission and the Council are trying to boost their own power, co-ordination will widen this gap. This was and is the case for the Maastricht criteria in connection with the Stability and Growth pact. The convergence criteria from the Maastricht together with the four European Fundamental Freedoms had been a solid concept for economic policy. There was a clear macroeconomic idea associated with the European competition law. In so far, fiscal policy is only part of this concept as the successful accomplishment of the Maastricht-criteria has to do with budgetary constraints and budget consolidation.

Apart from consolidation there exists no autonomy in the area of fiscal policy for the Commission and the Council of Ministers.<sup>27</sup> Whether the dichotomy between the European autonomy in monetary policy and the national autonomy

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<sup>26</sup> Bundesministerium für Wirtschaft und Technologie, Neuordnung des Finanzierungssystems der Europäischen Gemeinschaft, Gutachten erstattet vom Wissenschaftlichen Beirat beim Bundesministerium für Wirtschaft und Technologie, Dokumentation Nr. 455, Bonn 1998 sowie das Zeitgespräch im Wirtschaftsdienst „Wie viel Verfassung braucht Europa?“, Heft 6, 2002, p. 319 ff.

<sup>27</sup> See Bundesministerium der Finanzen, Verstärkte Koordinierung der antizyklischen Stabilitätspolitik in Europa?, Gutachten erstattet vom Wissenschaftlichen Beirat beim Bundesministerium der Finanzen, Berlin 2002.

in fiscal policy will persist for ever is an unanswered question.<sup>28</sup> The answer will depend on the future of the budget and tax autonomy of the EU which has to be seen in the context of the European constitution and its financial part.

Concerning the existing budget of the European Union, which is mainly a kind of transfer budget, there are needs for changes on the expenditure as well as on the revenue side. One proposal is to separate the EU-budget into two parts: one for allocational and the other for distributional functions. European wide goods as they are found in the area of foreign policy, defence and security policy (incl. anti-terrorism), environmental policy, in the framework for research and education, trade policy, transnational networks or certain parts of tax policy could be seen on the expenditure side of this new allocational budget.<sup>29</sup> The revenues for such a budget are to be financed through a European tax on the basis of the benefit or equivalence principle in contrast to the status quo. There we mainly find a distributional logic, meaning political considerations largely based on bargaining power. This proposal can be justified, looking at the present budget with its enormous part of agricultural and structural expenditures.<sup>30</sup>

This approach of two budgets goes together with a new economic geography concentrating on the specific regional effects in different fields of economic policy.<sup>31</sup> The problem is that there are fields of economic policy that do not need a European wide solution but an interregional solution between more than one

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<sup>28</sup> Deutsche Bundesbank, (Hrsg.), *Recent Developments in Financial Systems and their Challenges for Economic Policy: A European Perspective*. Reden anlässlich einer Konferenz in Frankfurt am Main am 28./29. September 2000. In this publication there are arguments about a possible debt autonomy for Brussels in order to better pursue monetary policy on the “open market”.

<sup>29</sup> See in more detail Blankart, Ch. B. and Kirchner, Ch., *The Deadlock of the EU Budget: An Economic Analysis of Ways In and Ways Out*, in: Blankart, Ch. B. and Mueller, D. C., ed., *A Constitution for the European Union*, Cambridge, Massachusetts 2004, p. 109-138.

<sup>30</sup> See in more depth Milbrandt, B., *Die Finanzierung der Europäischen Union: Perspektiven für eine Osterweiterung*, Baden-Baden 2001.

<sup>31</sup> For the results of new geographical economy see in detail Krugman, P., *Geography and Trade*, Cambridge, Mass. 1991 or Fujita, M., Krugman, P., Venable, A. J., *The Spatial Economy, Cities, Regions, and International Trade*, Cambridge, Mass. 1999.

nation, e.g. in the newly developing functional EUREGIOS fiscal equivalence and competition could be the new basis.

“Solidarity”, distribution and political rationality may be achieved in the transfer budget within the current intergovernmental fiscal relations. The financing for this part of the budget could stem from contributions paid to Brussels on the basis of the GNPs of the member states together with the own resources in form of duties etc. as it is now already the case. The value-added tax with its tax-base for calculating the contributions should be abolished for distributive reasons and substituted by the existing proportional “GNP-tax” which could be made progressive by charging more from countries with a higher per capita income.<sup>32</sup>

## **6) Summary**

The “constitutional and allocational view of co-ordination” comprises

- the monetary policy as a consequence of the Single Market and
- the market economy and competition law as the fundamental economic framework of the European Union.

These hard rules for a European economic policy include the search for more regions (EUREGIOS) to better fulfil the elements of fiscal equivalence in the different areas of European economic policy with their specific different structures and processes (e.g. planning, deciding, implementing, controlling).

The “political view of soft co-ordination” with its great interest from the media, in particular the so-called open method of co-ordination, should not only consist of

- benchmarking and the discussion of
- best practices. It should also include

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<sup>32</sup> See Peffekoven, R., Die Finanzen der Europäischen Union, Mannheim 1994 and Henke, K.-D., Sozialproduktsteuer, Wirtschaftswissenschaftliches Studium 17 1988, p. 140 - 142.

- more information about different legal frameworks and incentive structures, i.e. the potential for privatisation in the sense of the European treaty.

These elements of co-ordination could be given as a guideline to the “subsidiarity watchdog” that many experts are asking for to avoid that European institutions allocate too much power to themselves.

Thus, an economic constitution is postulated on the basis of more market economy with outcome-oriented financial incentives. Furthermore, a financial constitution and more fiscal equivalence in the different processes of governmental responsibility can be accomplished among different levels of government. This procedure would minimize market and government failure at the same time.

To remember, this paper tried to find a better framework for the co-ordination issue only from four different standpoints of economics. Other disciplines, i.e. political science, jurisprudence or historians may add on to this picture. The economic approach shows that a common European economic policy has a clear conceptual basis that would lead a “watchdog” in the right direction when managing subsidiarity.



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