The Political Economy of the European Constitution

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Chapter 1

The European Economic Constitution

Luigi Paganetto

A Constitution, at least in a liberal version, is a set of laws and procedures aimed at protecting citizens' rights and individuals from the will of Government.

The European Economic Constitution has to create a coherent architecture within this definition, set out principles and define the precise meaning of concepts such as vertical and horizontal subsidiarity, market liberalisation and market surveillance, as well as the regulation of capital mobility and budgetary balance.

The issue of the European Constitution therefore refers not only to a simplification of the Community Treaties – an exercise that the European Convention has done essentially in the second part of the new Treaty establishing a European Constitution – but also, and most of all, to the relationship between the system of the European Community and constitutional system of the Member States within the prospect of a common constitutional order. A political Constitution should be complementary to the existing economic Constitutions, and consistent with Community Treaties that created a common market and currency union.

The real, never-ending central concern, relates to the allocation of policymaking prerogatives between national and European authorities. Some authors think that a 'European Constitution' should be adopted as a basis for the establishment of a future European Federal State. Being in favour of such a Constitution often means being in favour of the establishment of a Federal or a Confederal European State. A confederation of states, however, does not constitute a new state, just an association of sovereign states, while a federal state, as its name indicates, is both state and federation.

The nature of European Union has long been debated and there are many definitions regarding such a Union. According to Alberta Sbragia 'the European Community is […] unique in its institutional structure, it is neither a State nor an international organization […]' to use Helen Wallace's words, 'a part-formed political system'.[1] To Keohane and Hoffmann[2] 'If any traditional model were to be applied, it would be that of a confederation rather than a federation [p. 279] […] However, confederalism alone fails to capture the complexity of the interest-based bargaining that now prevails in the Community [p. 280] […] the European Community […] exemplifies what sociologists refer to as a *network form of organization*' [p. 281].

1 Sbragia, A. (1992), *Euro-politics: Institutions and Policy-making in the 'New' European Community* (Washington, DC: Brooking Institutions).

2 In Wallace, W. (Ed.) (1990), *The Dynamics of European Integration* (London: Pinter).

Philip Schmitter once proposed five models based on the domination/integration relation: *national state*, *confederatio*, *condominio*, *federatio*, *supra-state*.[3] Otherwise the EC/EU has been defined as 'a loose federation',[4] 'une entité post-étatique',[5] un 'objet politique non identifié',[6] 'a multi-tiered system of governance',[7] 'a multi-tier negotiating system',[8] 'a multi-level European system',[9] 'a mixed polity',[10] 'a polity creating process in which authority and policy-making influence are shared across multiple levels of government'.[11] In Wessels and Maurer's words: 'Whatever the language used, political scientists and lawyers classify the EC/EU as a system for joint decision-making in which actors from two or more levels of governance interact in order to solve common and commonly identified problems'.[12]

Indeed, the institutional design of a federation is the fruit of a compromise between two different objectives: the internalisation of externalities amongst countries and the adaptability of policies to different national preferences. The benefits from internalisation of externalities increase in the degree of interdependence between countries, while the benefits from adaptability of the policy increase with heterogeneity between countries. A union in which every country independently chooses its policy maximises the adaptability to local differences, but minimises the internalisation, and does not take into account heterogeneity between countries (Alesina *et al*., 2001).[13]

The analysis of the relationship between corporatism, institutions and growth has recently been performed by a coincidence of theoretical and empirical research initiatives which have focused the debate on different perspectives and heterogeneous analytical paradigms.

Some theoretical contributions (Freeman, 2001, and Phelp, 2000), for instance, have examined the supposed convergence of the western European system of

3 Schmitter, P.C. (1991), *The European Community as an Emergent and Novel Form of Political Domination*, Working Paper 1991/26, (Madrid, Juan March Institute).

4 Wallace, W. in: Wallace, H. and Wallace, W. (Eds) (1996), *Policy-Making in the European Union*, 3rd edn (Oxford: Oxford University Press).

5 Telò, M. (1995), *L'Italia nel processo di costruzione europea*, in *Storia dell'Italia Repubblicana*, Vol. 3, (Torino: Einaudi).

6 Quermonne, J.-L., (1992), Existe-t-il un modèle politique européen?, in *Revue Française de Science Politiques*, April 1992.

7 Lodge, J. (1995), *Institutions and Policies of the European Community* (London: Frances Pinter).

8 Kohler-Koch, B. (1996), Catching up with change: the transformation of governance in the European Union, *Journal of European Public Policy*, 3(3), September, p. 360.

9 Scharpf, F. (1994), *Community and Autonomy: Multilevel Policy-Making in the European Union*, EUI Working papers of the Robert Schuman Center, RSC 94/1.

10 Andersen, S. and Eliassen, K. (Eds) (1996), *The European Union. How Democratic is it?* (London: SAGE).

11 Marks, G., Hooghe, L. and Blank, K. (1995), *European Integration and the State*, EUI Working papers of the Robert Schuman Center, RSC 1995/7.

12 Wessels, W. and Maurer, A. (2001), *The Evolution of the EU system: Offers and Demands for National Actors*, paper for ECSA Conference, Madison, June, p. 5.

13 Alesina, A. *et al*. (2001), *Institutional Rules for Federations*, mimeo, Harvard University and European Central Bank.

governance to the 'American model'. Endogenous growth literature has highlighted the role of institutional and policy variables' influences, and the steady-state equilibrium of economic expansion, with an emphasis on the consequences of an income distribution process (Bertola, 1993; Alesina and Perotti, 1993; Rodrick, 1999). Public choice literature and labour economics have mainly investigated whether and how different governance structures and wage-bargaining systems affect macroeconomic performance. Some political science models have introduced the role of government partnership and unionisation to extend the analysis of corporatism beyond distributive aspects, to include other policy dimensions of economic institutions (Traxler *et al*., 1997).

The accessing process of the CEECs (Central and East European Countries) opens in the first part of the 1990s with the 'European Agreements' (so-called Association agreements of the 'second generation'). These treaties define new relationships between the European Union and each member of the CEECs (Central and East European Countries). Initially the process was aimed at creating a free trade area, but the final purpose was the accession of former socialist countries to the Union. In 1993, during the Copenhagen European Council, the entrance criteria were fixed and negotiations were started with four CEECs (Poland, the Czech Republic, Hungary and Slovakia). Between 1994 and 1997 the agreements were extended to most of the CEECs. Negotiations for accession started in 1998 for Estonia, Poland, the Czech Republic, Slovenia, Hungary and Cyprus and, in 1999, were extended to Bulgaria, Latvia, Lithuania, Romania, Slovakia and other non-CEEC countries such as Turkey and Malta. On 1 May 2004, ten new countries entered the European Union, and Romania and Bulgaria became members on 1 January 2007. However, the current political turmoil and the EU's slow economic growth have cast some doubts on whether the EU will be ready to accept new members after 2007 (Croatia, Macedonia and Turkey are official candidate countries; Serbia and Montenegro, Albania, Bosnia and Herzegovina are potential candidate countries).

Alesina *et al*. (2001) have formalised a model in which the issue of Union enlargement is examined by looking at those factors that allow the admittance of a new member by majority rule. The authors maintain that 'only those countries with positive externalities with UE nations, would be admitted as members the Union so that the new entrance doesn't change the median, otherwise at least 50 per cent of the members would object to that' (Alesina et al., 2001, p. 22). They also point out that members of a union tend to favour the entry of new countries only if they have similar preferences to their own.

As the new EU members are much poorer than the current ones, the prospect of further enlargement of the EU gives an emphasis to the issue of regional gaps within the Union. The ongoing process implies several questions about the effects of economic integration on growth and convergence and on optimal policy design.

The enlargement could produce a widening of regional gaps within Europe, which calls for a careful analysis of the cohesion policy models adopted by the EU policy makers. A rethinking has already started in the direction of supply-side interventions stimulating the entrepreneurial environment and promoting competitiveness of local system by capital inflows (Kostoris *et al*., 2002).

Strong economic arguments in favour of a strengthening of regional policy in an economic union stem from the less-optimistic conclusions on the distribution of gains from integration, reached by theoretical and empirical economic geography (Krugman, 1991; Krugman and Venables, 1995) and endogenous growth literature (Romer, 1986) in which increasing returns and local externalities dominate.

A cohesion policy has become one of the pillars of Europe (e.g. in building the Maastricht Treaty); however, the Agenda 2000 negotiations have pointed out the need for reform in light of enlargement. The following problems have also been stressed: a more rigid budget constraint for regional policy, due also to the burden of pre-accession transfers; a reduction in the number of subsidized areas; and a restriction of the focus of interventions on fewer objectives. In addition, the need to simplify the complex apparatus associated with the allocation of structural funds, and for better coordination among different levels of governance (regions, nations and community), becomes more important as the political and institutional diversity of the members increases (Nizzo, 2001). Nizzo argues that looking for a new cohesion policy goes along with a better consideration of two complementary policies – national development policies (both members and candidate) and EU competition policy (discipline of government aids to the firms and regions). Nizzo (2001) sketches two different reform options. One is based on a differentiation of the policy between previous members and new members –the former would be allocated funds with the old system, and the latter would receive transfers at national level – to avoid competition between regions of current members and regions of new members. The other reform would be based on the subsidiarity principle: the management of the regional development policy would be left to the national level, with a financial contribution from the Union according to the GDP level. The Union competence would be restricted to some specific actions, such as cross-border programmes, transnational cooperations, strategic innovation policy.

Therefore, reform of regional policy includes the fundamental issue of institutional and devolution policies. The decentralisation process is fundamental for regional development, as defining the appropriate level of intervention allows policies to be modulated in relation to the need of the intervention area (bottom-up approach). A decision on the shape of regional policy should be made by local authorities (Maggioni and Bramanti, 2001).

The aspect of the allocation of economic competencies represents one important aspect of the European constitutional debate. Following the normative view of fiscal federalism, there are no reasons for supranational competence in the area of regional policy as it would imply a negligence of individual preferences. The only cases in which this theory admits a central intervention by the member states or by a supranational competence are those where external spillovers arise (interregional externalities) in neighbouring regions belonging to the same country or belonging to different countries (border regions). However, in this case it is also not necessarily an allocation of regional policy competence to the supranational level as transborder extenalities may be internalized by fixing bilateral rules (the Coase Theorem) (Stehn, 2002).

Another question is whether there should be a unique European Social Welfare State (ESWS) model. In addition, if this unique model is to exist, the main problem is then to define the desired level of the ESWS; shall all countries converge toward a minimum common welfare level or to a higher level similar to that of the North European Countries?

To date, the EU policy is quite vague; in fact, whereas there is an explicit common target in terms of financial indicators (defined within the Maastricht Treaty in 1992) there is no target in terms of social protection policies.

In addition, another debated issue is how to proceed with respect to social policy matters.

Notwithstanding commitments to guarantee adequate levels of protection, as advocated and renewed in Article 2 of the Maastricht Treaty, the problems of financing such programmes pose alarming prospects for the implementation of the various protection policies in the member countries.

Hence, one possible consequence of this forced integration is the dismantling of the European social protection systems. As Sinn (1998) stresses, the increasing competitive pressures on national fiscal systems may generate a race-to-the-bottom in terms of social welfare provision. The tighter restrictions thereby imposed upon national budgets to meet economic parameters of entry into the EU have played an important role in conditioning programs that have attempted to improve the social protection system.

The need to bring together social intervention policies at the EU level is stressed by Bertola *et al*. (1999) who argue that 'the failure to provide guidance on the challenges facing social provision at the country level, in light of the removal of economic borders across the Union, exposes European policies to the twin risk of inertia on the one hand, and uncoordinated and unsustainable reforms on the other'.

In order to explore the possibility of a single European Constitution it is of great help to review the state of the art in the field of governance. Within the European countries, a double dichotomy result is pretty evident. At first glance, the Anglo-American corporate system seems to be characterized by dispersed ownership and by a market-based financial system. On the other hand, continental Europe is characterized by concentrated ownership and a bank-based financial system. These aspects are not disjoint, but they can be seen as two sides of the same coin. It is a mixture of economic, political and cultural factors that has been determining the current shape of the European corporate and financial system. Decisions that have once been made and pursued, have led to path-dependent developments and will not be easily overturned – as long as other new forces are not strong enough to bring about a change. Theories that attempt to explain the prevalence of one form of ownership structure in a given country are equally valid in explaining why that particular form of financial market prevailed.

Theories attempting to explain the lack of ownership diffusion in continental Europe can ideally be divided into two broad categories: technical and socio-political. The accounting system, institutional structure and differences in law protecting minority stockholdings, are the most popular technical explanations. In the second group we find the cultural and the social democracy theories. The theory based on the accounting system postulates that ownership does not diffuse where full disclosures are unavailable, since small investors are reluctant to invest in firms because these investors cannot be sure of the actual economic and financial situation.

Regulatory rule from another jurisdiction will not guarantee a similar outcome. Instead, the likely impact of a proposed rule must be examined in terms of the institutional context into which it is being placed.

In this context, it would be interesting to analyse the regulatory reform programmes covering telecommunications, energy (electricity and gas), transport (urban, air and rail) and water, fostered by the European Union since 2000. The extent to which network industries have already been liberalized in the Euro area differs significantly between the various sectors and countries. The telecommunications and electricity sectors are currently attracting the most attention, while the opening up of the gas sector only began very recently. From a theoretical point of view, the fundamental regulatory problem is the goal of stimulating private investment for public utility infrastructure. In particular, one of the possible interpretations of this problem is one that treats regulation as a contracting problem between government and the provider, for which the political and social institutions of a nation must provide sufficient credibility in order to mitigate the threat of expropriation and thereby encourage private investment.

The regulation problem can even be seen in the perspective of the interest group theory, employing a model in which two opposing interest groups seek to influence the decision of a standing regulation. In this way it is possible to examine the impact of exogenous changes in economic conditions and the effects of such changes on the marginal cost of exerting pressure for favourable regulatory decisions. Such policy changes may be spurred by shifting economic conditions. Interesting work in this sense has recently been done, for instance, by David Coen and Adrienne Heritier,[14] and Giandomenico Majone's work on regulatory and deregulatory policies in the EU.

However, recent events – the substantial failure of the so-called Lisbon Strategy, the vote in the European Parliament on the directive on services, the reticence of member States against liberalisation of services (especially the Suez–GdF case), not to mention the French and Dutch votes against the Constitutional treaty – clearly show how the future status of the European Union, therefore, continues to be the subject of political controversy, with widely differing views between Member States.

Major issues currently facing the European Union include, among others, the adoption, abandonment or adjustment of the Constitutional Treaty, the future budget and the Union's enlargement. The accession of Turkey is a major issue of contention among EU member states. Turkey's ambitions date back to the 1963 Ankara Agreements. Preliminary negotiations for membership between Turkey and the EU began on 3 October 2005. Since it has been granted official candidate status, Turkey has enacted many legal reforms to meet the EU's entry requirements. However, due to its religious and cultural differences, Turkey's membership of the EU faces strong opposition from governments of some Member States, which repudiate the possible economic, immigration and cultural implications that it may bring. Analysts believe 2015 is the earliest date the country can join the Union.

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14 Coen, D. and Héritier, A. (Eds) (2005), *Refining Regulatory Regimes: Utilities in Europe* (Cheltenham: Edward Elgar).

As far as the budget is concerned, after the failure of the negotiations of the 16–17 June 2005 European Council in Brussels, where the EU member States' leaders failed to agree on the common budget,[15] the EU member States, at the December 2005 European Council, finally adopted a decision about the EU budget for the seven years 2007–2013. However, many commentators have envisaged that these debates will yield a major split between governments who call for a broader budget and a more federal union, and governments who demand a slimmer budget.

In short, tension continues to exist within the European Union between the supporters of the intergovernmental method on one side and of the Community method on the other.

15 The more controversial issues were the British rebate, negotiated by Margaret Thatcher in 1984, and France's benefits from the Common Agricultural Policy.

Chapter 2

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

Jürgen Stehn

The Problem

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

The objective of this chapter is to provide an economic rationale for further discussions in the European Convention. The following section will build up a reference system – based on the theory of fiscal federalism – for an economically optimal allocation of competencies within a supranational body like the EU. On basis of the theoretical analysis, the third section proposes an allocation of economic competencies that can serve as an overall guideline for the discussion on establishing an European constitution. The fourth section draws conclusions.

Fiscal Federalism and the Optimal Degree of Economic Integration

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

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

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

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

A simple graph can illustrate the welfare losses due to a centralization of competencies (Figure 2.1). For simplification, this graph is based upon the assumption that a nation state can be divided in two regions. Within each region, consumers' preferences with respect to the supply of public goods and services are homogeneous. Thus, the curves D_1 and D_2 illustrate the demand for public goods in region 1 and 2, respectively. A central supply of public goods and services requires a political compromise between the demand of region 1, which amounts to x_1, and region 2, which is given by x_2. In the case that x_3 is the compromise solution, the triangle ABC indicates the welfare losses per head in region 1. In this region, consumers are forced to buy more public goods and services than they wish to. The welfare losses per head in region 2 are given by the triangle CDE that mirrors the decrease in consumer rents due to an undersupply with public goods. This part illustrates the well-known Oates effect (Oates, 1972).

In addition to the Oates effect, there is another effect that leads to additional welfare losses in the case of a centralisation of competencies. It can be realistically

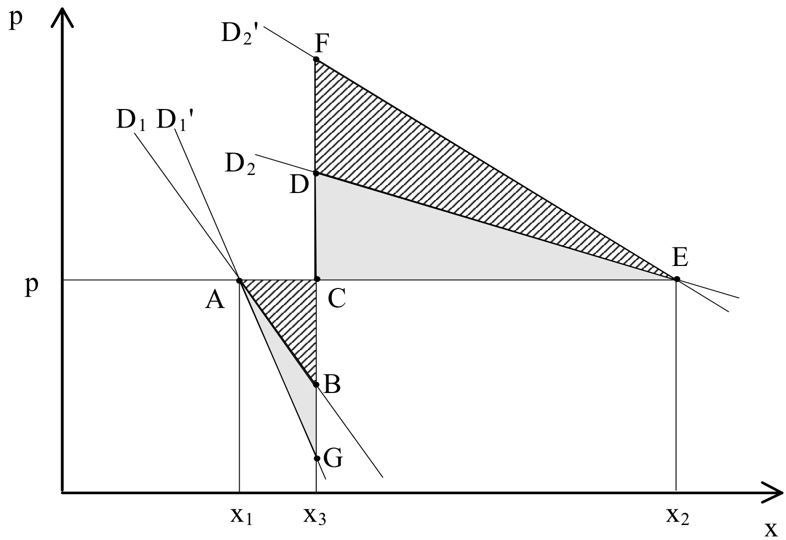

Figure 2.1 Welfare losses due to a centralisation of economic competencies

assumed that the elasticity of demand will decrease after a centralisation of competencies on a higher government entity, because the costs that consumers have to bear for gathering information on the true price (i.e. the tax burden) of a specific public good rise sharply if a central government entity takes over a huge bundle of different public tasks. This case is illustrated by the demand curves D'_1 and D'_2. The elasticity effect increases the welfare losses compared with the Oates effect on AGC in region 1 and CEF in region 2.

As a general rule, the strong economic principle of subsidiarity recommends that economic competencies should be transferred to the lowest possible government body. Only if a transfer of competencies to the supranational level leads to efficiency gains that exceed the welfare losses due to a centralization, should national and regional responsibility be replaced by supranational competencies (Figure 2.1).

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

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

In other words, for a given distribution of preferences by potential union members and over a diverse range of policies, in equilibrium one should observe either small unions that centralize many competencies, or large unions in which few competencies are delegated above national governments. This trade-off is particularly important when the union is considering enlargement. According to this reasoning, enlargement of the union and a deepening of the coordination of policies are contradictory if the new members and the incumbents are heterogeneous. How the union would choose along this trade-off depends on the voting rules within the union.

This is why the discussion about what a union should do is deeply linked to the constitutional issues concerning ‘who decides what and how’. Alesina *et al*. (2001c) discuss the possibility of a centralization bias in the unions. If the centralization of tasks in the union is not defined ex ante by constitutional design, the members close to the ‘median’ have an incentive to increase centralization and harmonization. Anticipating this tendency, potential members will stay out to begin with, leasing to unions that are ‘too small’. A union where competencies are fixed ex ante leads to superior outcomes.

The Allocation of Economic Competencies in a European Constitution: Some Overall Guidelines

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

(1) the common trade policy vis-à-vis third countries and the liberalization of intra-community trade (trade policy);
(2) the supervision of cartels, mergers and acquisitions as well as sectoral and regional subsidies of the member states (competition policy);
(3) the allocation of regional subsidies to backward regions as a main task of the European Structural Funds (regional policy);
(4) the Common Agriculture Policy (CAP);
(5) the promotion of basic and applied research (research policy);
(6) the establishment of common norms for the protection of the environment (environmental policy).

It is obvious that the EU has taken over a broad range of responsibilities in economic policy that are by no means the result of ex ante considerations of the pros and cons of a centralization of economic competencies. Thus, in the course of a formulation of a

European Constitution, it is high time to base the allocation of economic competencies on sound economic theories such as the theory of fiscal federalism. What does this theory recommend with regard to the current supranational competencies of the EU?

Trade Policy

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

A positive explanation for this neo-mercantilist perspective is provided by the new economic theory of politics, which assumes that politicians – like other economic actors – are striving for the maximization of their own utility. From the perspective of individual utility maximization, it can be rational to erect trade barriers or grant subsidies in order to gain votes from influential interest groups. This is especially the case if the search costs that consumers and taxpayers have to bear during their attempt to get information about the effects of public protection measures are higher than the utility arising from additional information. Under these conditions, political decision-maker are more or less free to gain votes from influential interest groups without losing support from consumers and taxpayers.

To be sure, countries that make excessive use of subsidies and protection measures will generally lose international competitiveness in the medium term and politicians will be pushed back on to the liberalization path when a potential decrease of real income makes it profitable for consumers and taxpayers to bear the high information and lobbying costs. However, these market forces are more or less toothless if member countries build up a protection or subsidy cartel by harmonizing their defensive trade and competition strategies. In this case, only an outsider, who is ready to leave the cartel and to serve as some sort of 'lender of last market' by unilaterally liberalizing his/her own home markets, is in a position to break the cartel. However, such an outsider strategy bears high risks since the short time gains from liberalization are generally relatively low, whereas the material losses of interest groups induced by a liberalization of markets are relatively high in the short run. Thus, only countries that have a long tradition of successfully liberalizing markets and that are economically strong with regard to growth and innovation will take the risk to refrain from common protection strategies. For example, the US took over a leading role as an outsider in the multilateral trade negotiations within the GATT until the early 1980s. This was because the US were economically strong enough to keep special domestic interests under control and was, therefore, in a position to make the first step to a new round of worldwide negotiations by offering multilateral concessions that brought all parties back to the table.

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

Competition Policy

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

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

However, this is not to say that the current subsidy supervision ('aid supervision', as the EU-Commission puts it) should stay unchanged.[1] The current supervision

1 See Stehn (2000) for an evaluation of multilateral regulation for the granting of subsidies.

system leaves a broad leeway for discretion by the EU-Commission, because it lacks binding, transparent, and enforceable rules for the granting of national subsidies. Any supranational subsidy scheme has to take into account that some public subsidies are granted to improve the efficiency of national economies by internalizing non-pecuniary externalities. There is no doubt that the funding of universities, public research institutes, and public infrastructure in a broad sense belongs to this group of subsidies. These activities should, therefore, be excluded from a supranational supervision system.

All subsidies that are categorized as non-efficient should be ranked according to their potential competition (trade) distortion effects. It can be realistically assumed that the competition effects of subsidies are the higher, the closer the respective subsidy base is to the end of the value-added chain of a firm. For example, an export subsidy, i.e. a subsidy for the sale of a product, might result in stronger competition effects than a subsidy to basic R&D. Hence, all non-efficient subsidies should be grouped in one of the following seven categories: (1) subsidies to basic R&D; (2) subsidies to applied R&D; (3) subsidies for the adaptation to new environmental standards; (4) investment subsidies (including regional subsidies); (5) production subsidies; (6) sales subsidies (export subsidies, import substitution subsidies); and, as a special case, (7) subsidies for promoting the general operation of firms or industries (subsidies covering the losses of firms, debt forgiveness, etc).

For each category, quantitative thresholds should be set that limit the provision of subsidies to a certain fraction of the respective subsidy base. The thresholds should roughly reflect the potential competition distortion effects of the different kinds of subsidies. One proposal would be to set thresholds of 30 percent for subsidies to basic R&D, 15 percent for subsidies to applied R&D, 10 percent for environmental subsidies, 10 and 5 percent for investment subsidies in backward and 'normal' regions respectively, 5 percent for production subsidies, and 0 percent for sale subsidies and subsidies promoting the general operation of firms. In order to prevent specific firms from gaining disproportionately from certain kinds of subsidies and to facilitate the calculation of the actual subsidization rates, the thresholds should be defined on a firm-specific basis.

Regional Policy

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

From the normative perspective of fiscal federalism, there are almost no reasons for supranational competencies in the area of regional policy. Externalities arising from a subsidization of local enterprises and local infrastructure projects are generally confined to the subsidized region itself. At most, externalities may arise in