Institutional aspects of EU organization: an economic analysis

By Massimo Bordignon, Catholic University of Milan and CESifo

Paper prepared for the CESifo-Delphi 2004 Conference, Designing the New EU.

Revised version: 31/01/2005

* This is an amended and extended version of a paper I gave at the CESifo-Delphi Conference, Designing the New EU, in Delphi, June 2004. I wish to thank an anonymous referee for her/his very useful suggestions in revising the paper, the two organizers, Helge Berger and Thomas Moulto, for their patience, support and encouragement in writing this paper, and all the participants at the Conference, in particular Giuseppe Bertola, Gerard Roland and Jurgen Von Hagen, for their very useful comments on the early version of this paper. Furthermore, as will be apparent from what follows, this paper is also strongly indebted to my joint works with several co-authors, in particular, Sandro Brusco, Luca Colombo and Umberto Galmarini. While their contribution to the ideas of this paper should be emphasised, they are not responsible for any of the errors here contained.
1. Introduction

The European Union (EU) is a strange animal. It has similar institutions of other existing federations, but it is not a federal state, not even a somewhat looser version of it (say, a Confederation such as Switzerland). True, the EU has a Central Government (the Commission), a Senate representing the States (the Council), a Parliament representing the People, even a Constitutional Court. But these European federal institutions perform a very different and in general much more limited role than that of the similar institutions of other consolidated federations. The amount of powers still concentrated in the member states, the quality and the extent of these powers, the smallness of the European budget, the lack of true executive powers by the EU government, the residual role still played by the European Parliament in passing legislation, and more generally, the absence of any true pan-European issue at stake in the day by day politics of the member states makes the EU completely different from any other known federation. To date, for example, the EU does not even have a common foreign policy or a common defense policy; the European Parliament cannot propose new legislature, and the European Government is not elected but appointed by the Council\(^1\). On the other hand, the EU is clearly far more than a simple economic agreement among sovereign states. True, it does share with an economic union many features, such as a common internal market and, for those members who joined the EMU, even a common currency. But the extent of powers transferred to the center in determining, for instance, competition and monetary policy, has no parallel in other existing economic agreements, and makes the EU a by far more politically and economically integrated region than, say, Nafta.

These peculiar characteristics should warn scholars from using the knowledge accumulated on other federations to analyze the workings of the EU. One can certainly learn something from these other experiences. But in many cases it seems more advisable to attempt to analyze the European institutions in their own terms, because it may be that is only in this context that they gain their meaning\(^2\). Take, for instance, the problem of the optimal attribution of functions to different levels of government, a fundamental issue discussed at large in the fiscal federalism literature. Economists have since long developed a recipe to address this issue (e.g. Oates, 1972). But this recipe seems to be of a little use when the “central government” has the peculiar characteristics of the European Commission. Or take the issue of the optimal allocation of taxing powers to sub-central governments. Again, it makes a lot of difference if this problem is discussed in a context where the central government has large taxing powers of its own (as in most existing federations) or in a context where it has not (as in the EU) (Keen, 1998). And the examples could go on. In short, what
seems we would be needing is an economic analysis which takes fully into account the peculiar institutional characteristics of the EU.

In the following, I am going to present some elements of this analysis. The paper builds upon some more formal work which I have developed together with other co-authors on specific issues of European concern. But more than in the results of the single papers, I am here mainly interested in underlining the common methodology used in these papers. We are very far from having a satisfactory understanding of the working of the European institutions, but I believe these works may offer some suggestions on how we could proceed. Focussing first on a detailed analysis of the EU institutions for the problem at hand, they help clarifying the issues for the subsequent theoretical research, putting in evidence unexpected policy implications and offering explanations for otherwise hard to explain facts.

I will be discussing here two issues of relevance for the EU; the introduction of formal rules to form sub-unions inside the EU (known as Enhanced Cooperation Agreements in the jargon of the European Treaties) and, more briefly as space is limited, the problem of the optimal allocation of functions to the Union and the member states on the supply side of the economy, where the “open method of coordination” now prevails. To emphasize the common methodology used in these more formal works, I will present their main insights following the same structure. Thus, I will start by explaining the importance of the problem in the European context and why this problem presents particular features inside the European Union; I will then move to illustrate briefly the model used to address the issues and the main results obtained; and finally, I will discuss the main insights and policy implications which follow from the analysis.

The rest of the paper is organized as follows. Section 2 discusses the problem of sub-unions formation and governance inside the EU. Section 3 analyses the problem of the allocation of functions. Section 4 concludes, by briefly suggesting further avenues for research.

2. On Enhanced Cooperation

2.1 The problem
At bird’s eye, the EU as a working federation has clearly two main problems. First, it is becoming increasingly heterogeneous. The EU was internally differentiated to start with, but the enlargement
to 10 new countries in the 2004 has transformed the EU in a vast area of very heterogeneous countries, differentiated by size, population, history, institutions, language and levels of economic development. The difference in GDP per capita from the richest to the poorest country skyrocketed after the enlargement; and the new accession countries have obviously a need for very different policies than the more mature market economies of the original members. *This means that it is becoming more and more difficult to find common policies which could benefit all, or most of, the members of the EU*. Second, the EU’s decision making is becoming increasingly cumbersome. Unanimously agreeing to efficient decision making rules for an Union with 25 different members has proved to be extremely difficult, as member countries resisted surrendering sovereignty to the European institutions. The current version of the Founding Treaty, the Treaty of Nice, which was supposed to streamline the EU institutions to make them able to deliver even with 25 members has been a disaster on these grounds (Baldwin et al., 2001), making it more difficult for the Council to reach decisions even in those areas formally under qualified majority rule. The recently approved (by the European Council) European Constitution (June 2004), with its modification of decision rules for the Council starting with 2009, has still to be ratified in many countries to become effective, and in any case it has still to prove to be able to work. *This means that not only is becoming more difficult to find common beneficial policies, but it also becoming more difficult to have them implemented by the EU.*

In addressing these problems, the EU legislators have possibly found a working solution, one which has no parallel in other existing real world federations. Faced with the dilemma between keeping proposing integration of a given function at the European level, at the risk of hurting some member countries and finding therefore it impossible to have the proposal approved by the Council, or giving up altogether integration policies which could instead benefit a large subset of member countries, the EU legislators have opted for an intermediate solution. Namely, *the possibility for only subsets of member countries to go on with integration on some particular issue, following ex ante agreed upon decision and governance rules*. Or, to put it differently, the possibility for member countries to legally form sub-unions inside the larger EU. These sub-unions have been termed “Enhanced Cooperation Agreements” in the evocative language of the Treaty of Nice, or ECAs for short.

To be sure, the EU had always had to deal with sub-unions of member countries in its history. For example, the Shengen Treaty, initially approved by only a subset of members and then extended to the others, can well be considered as an *ante-litteram* example of an ECA. In a sense, even the
European Monetary Union, which currently covers only 12 countries, or less than half of the current members of the EU, can be thought of as an ECA.

There are some important differences, however. First, these previous examples of ECAs were the result of intergovernmental agreements, largely reached outside the formal working of the EU institutions. This is not the case with the current ECAs arrangements. As we will see shortly, there are precise rules, defined in the Treaty and therefore ex ante approved by all members, according to which subsets of members, if they wish to do so, can propose and then, if approved, form a sub-union on some issue. Importantly, this implies that at least in principle no subset of EU member countries can now form an ECA outside these rules, and that, vice-versa, no excluded country can oppose the formation of an ECA, once this is approved by the Commission and the Council following the agreed upon rules. Of course, it has yet to be seen if these rules are really binding, since they refer to what are still separate and sovereign countries. But the fact that the countries themselves have signed the Treaties introducing these rules gives them a legal and political force which no sovereign country can safely ignore. For example, an agreement between a subset of member countries in some of the matters covered by the Union, reached outside these formal proceedings, could well result in a legal case being put forward by the Commission or by the excluded countries against the European Court of Justice.

Another important difference is that in these previous examples of ECAs, sub-unions have always been thought of, and presented as, temporarily deviations from a common unifying trend. In the case of EMU, for example, some countries have been allowed “to opt out” from the monetary union for the time being, but the understanding, or at least the rhetoric of the agreement, was that eventually all EU members would join the sub-union. This is not so with the current arrangements. The Union may well wish this to happen, and the wordings of the Treaty makes it clear that this is the intention of the legislators, but there is no obligation for any member country to join a sub-union, either in the present or in the future, if it does not wish to do so. That is, the new rules open the way to an EU largely segmented internally, with different sub-groups of members, possibly partly overlapping, that coordinate their policy on different issues, a situation which could also go on indefinitely.

2.2 What are ECA’s?
Before going on, it is important to be more specific about the rules for forming an ECA in the current European Union Treaty (the Treaty of Nice) as this is essential to understand the analysis which follows. The current procedure to form an ECA was firstly introduced in the Amsterdam Treaty, signed in 1997. The Treaty of Nice (drafted in 2000, finally ratified by all countries in 2003) basically simply reproduces all these rules, but with an important difference. *Whereas under the Amsterdam Treaty any country could always block an ECA proposed by some other group of countries by invoking reasons of paramount “national interest”, this is no longer possible under the Treaty of Nice.* That is, the latter Treaty has effectively revoked the veto power that the previous Treaty still guaranteed to each member country, thus making ECAs much easier to implement. On these grounds, the Convention’s proposal (whose amended draft has been approved in June 2004 by the European Council) changes very little, except that it tends to make ECAs even easier, and to reduce further the difference in the rules for ECAs formation between the different “pillars” in which the functions of the EU are traditionally divided. I will indicate below when the proposals of the Convention may make a difference. The rules described below refer to the most important group of functions in the EU, the first pillar (Economics and the Common Market); the rules for the other two pillars are only slightly different, and are moreover in the process to converge to the first pillar rules following the Convention’s amendments.

According to the Treaty of Nice, then, to form an ECA:

1. At least 8 members of the EU (a third of the members, according to the Convention draft) must declare their willingness to form an ECA in one of the matters covered by the first pillar of the Treaty;

2. The European Commission evaluates this proposal and assesses its compatibility with the Common Market, the fundamental freedoms of the Treaty and the aquis communautaire. Following this assessment, the Commission then decides either to kill the sub-union, or to approve it. In the latter case, the Commission drafts a legislative proposal concerning the ECA which is then presented to the Council.

3. The Council decides, via Qualified Majority Voting, whether to accept the draft of the Commission or to reject it.

4. Once approved, an ECA is binding only for those countries who accept to be part of it. The decision rules inside the sub-union are the same as for the Union at large on the same subject. For instance, if, say, the ECA concerns direct taxation, decisions inside the sub-union are taken according to unanimity rule. In other cases, decisions are taken
according to Qualified Majority Rules, with each country maintaining the same number of votes it has in the Council at large.

5. The members of the Council, not belonging to the sub-union, may participate at the discussions concerning the sub-union policy, but only the actual members of the ECA have the right to vote. On the contrary, all members of the European Parliament (including therefore representatives of countries outside the sub-union) vote on the proposals coming from the sub-union, according to the same rules for Parliament rulings prescribed by the Union at large for the subject covered by the ECA.

6. All EU members presently outside the ECA may ask to join the ECA, provided that they “accept to comply with the decisions taken”. The European Commission is actually given a role in deciding whether outside countries may be allowed to join (the Commission, for example, may decide to set criteria to be fulfilled before an outside country is allowed in the sub-union), but the wordings of the Treaty makes it clear that in general all EU members who wish to join should be allowed inside the sub-union (the Convention draft further weakens the powers of the Commission in this context, making accession to the ECA basically automatic for all EU countries who want to join).

Three things should be noted about this procedure. First, in the current arrangements, a paramount role is given to the European Commission. It is the Commission who decides if accepting the proposal advanced by the countries in the first place, the Commission who drafts the proposal to be presented to the Council, and it is the Commission who finally sets up the criteria for admitting other countries. Second, the countries outside the ECA do not have a direct say in the policy of the ECA. Their interests, if any, in the matter covered by the ECA are represented by the Commission (made up, so far, by representatives of all EU countries, but in the process of being reduced in number following the recent constitutional reform: see below) and by the European Parliament. However, given the limited role still played by the latter in drafting European legislature, it is clear that it is mainly the Commission who plays the role of a guarantor for the interests of all EU members, both inside and outside the sub-union. Third, if they feel that they are somehow damaged by the ECA, outside members of the ECA have always the possibility to join the sub-union. But note that if they join the sub-union once this has already been formed, they are asked to “comply with the decisions taken”. Furthermore, their ability to affect the decisions inside the sub-union depends on the governance rules of the ECA itself, rules which in turn depend on the matter covered by the ECA, a point on which we will come back below.
Summing up, the political compromise found by the EU legislators with the current ECAs rules can perhaps be better synthesized as a “No Veto – No Exclusion” agreement. Countries not interested, or contrary to an integration policy on some issue, cannot any longer forbid (a consistent subset of) the other EU members to go on and harmonize their policies on that issue; on the other hand, no EU country can be any longer excluded from an integrated policy reached by other EU countries. Are these rules the solution to the EU’s problems?

2.3 ECAs: the debate

According to some observers, the answer is a clear-cut yes. For instance, at the end of their long and detailed report on the Treaty of Nice, Baldwin et al (2001) conclude by saying that “After the Treaty of Nice… ECA’s could become the main engine of future integration”. Other observers are less sure. Indeed, ECAs have generated a fierce debate among political scientists, lawyers and politicians. Some observe believe that ECAs represent the only realistic solution for a loose and heterogeneous federation such as the EU. Some others are instead more critical, fearing that ECAs will lead to the formation of a “two-speed” Europe. Others still believe that on the contrary ECAs fall way short of what the EU would really need, that is, effective political decision making to be reached through the extension of majority voting to a larger set of matters (maybe even all of them). However, this debate is largely impressionistic in nature; no formal or detailed analysis of the trade-offs induced by the specific rules for ECAs formation is offered in this literature. Economists, who are more equipped to offer this kind of analysis, have instead been largely silent on the matter, preferring to focus on other European problems.

There are some exceptions, however. In an earlier attempt to discuss this problem, Dewatripont et al. (MEI, 1995) briefly discuss the trade-offs induced by ECAs, which they term « flexible integration ». On the positive side, they emphasize the advantages of the sub-unions in terms of experimentation and learning on the pros and cons of political integration on a particular issue. In particular, they stress the “snow balling effect” of ECAs, an idea which also surfaces in Baldwin et al. (2001). Sub-unions which prove to be successful for their members, would promptly be followed by the other members of the EU, thus leading to (only) beneficial integration. On the negative side, they worry about the possible negative externalities that sub-unions could generate on the EU members outside the ECAs. In particular, they fear the consequences for the Common Market (the “Hard Core” of European Integration, in their words). Accordingly, they advocate a strong role for the European Commission (as the Guardian of the Common Market) as a gate-setter for ECAs formation. Alesina et al. (2003), by using a dynamic (median voter’s) model of union...
formation, detect instead a tendency in the EU versus excessive centralization (see also Alesina and Grilli, 1991). According to their analysis, the EU tends to remain smaller and with more functions allocated at the central level than it would be optimal. They consider different possible remedies, among which they also briefly discuss the use of ECAs\(^5\).

This is basically all we have on ECAs. Do they fully capture the trade-offs involved in sub-unions formation in the EU? Without disagreeing with some of the insights offered by the above analyses, in a joint work with Sandro Brusco (Bordignon and Brusco, 2003) we make a different point, one which we believe to be more relevant for the issue at hand. *The point is simply that the real world is dynamic and stochastic, and that the case for sub-unions should be assessed in a context which considers these two important real world characteristics.* “Stochastic” here simply means that political contingencies change in a way which cannot be precisely predicted at the present; as an effect, countries who decide not to join a sub-union today, may decide to do it tomorrow -- perhaps, as suggested by Dewatripont et al. (MEI, 1995), exactly because the sub-union has proved to be successful in the past. “Dynamic” here simply means that what happens today is going to affect what happens tomorrow. Institutions are like “state” variables, with largely irreversible effects: changes today are going to affect the possible changes tomorrow\(^6\). To make an obvious example: the UK decided to opt out from the EMU in 1998; pending a national referendum, it may now decide to enter into the monetary union agreement. But if the UK joined the EMU today this would not be the same thing as it had decided to join immediately. Institutions, including Central Banks, have their own hysteresis, one which cannot be reverted easily; in its objectives and in its internal workings, the European Central Bank nowadays certainly looks much more German (or French or Italian) than it would do had the UK joined immediately.

These are rather obvious observations; but they have far reaching implications. First, contrary to what suggested by Dewatripont et al. (MEI, 1995), they imply that *ECAs may damage excluded countries even if in the absence of any negative externality, either in the present or in the future.* If forming a sub-union today on some issue changes the standard of integration tomorrow on the same issue, countries who do not want to join the sub-union today, but who may have accepted integration on that issue tomorrow, may find themselves worse off than they would have been if the sub-union had been prohibited to start with. Second, this also suggests that *governance rules for sub-unions are far from trivial:* even in the absence of any negative externality, for example, it may make sense to let countries outside the sub-union to retain some decision powers on the sub-union policy, as this may help protecting them from future exploitation. If these arguments are correct,
the introduction of ECA’s would then give raise to a fundamental trade-off. On the plus side, ECA’s would allow countries who wish to form a sub-union today to reap efficiency benefits that would otherwise be lost (with the correlated possibilities of experimentation and learning to the advantage of all other countries). On the minus side, ECA’s also introduce a possible risks of exploitation for the excluded countries, if the latter also turn out to join the sub-union in the future. One can then ask, on positive grounds, if this trade-off this may actually help explaining some of the existing arrangements for ECA’s in the EU; and, on normative grounds, one may also be led to question the optimality of these same arrangements.

2.4 The analysis

To further clarify the issues involved, it may be useful to refer to the results of a simple model, which is discussed in more detail in Bordignon and Brusco (2003). As a working example for our analysis, we focus on the issue of corporate income tax harmonization at the European level. Of course, our argument on ECA is far more general, but this example illustrates very nicely the trade-off we are discussing here. Differences in legal and accounting rules for corporate taxation across the European countries are well known to represent one of the main obstacles for an efficient allocation of capital in Europe (e.g. Bond et al., 2000 and the Ruding Committee, 1992). Corporate tax bases and taxable profits are determined in different ways in the different EU countries. As a result, computing the net of tax return from an investment abroad might be a nightmare for any EU investor, and this may induce firms, and in particular small firms, to give up otherwise productive investments in the other EU countries. Years of discussions and even several European Commission proposals for across-the-board harmonization have not gone anywhere. The difference in current practices across European countries is simply too large for all of them to agree to pay the costs of the adoption of a common standard for taxing corporations. Furthermore, the overall benefits - and their distribution across countries- of a harmonization policy are very difficult to assess at the present. For these reasons, and also because direct taxation legislation can only be approved via unanimity ruling in the Council, all attempts of harmonization have so far failed. However, for historical reasons, differences in accounting standards are lower for subsets of the EU countries than they are for the Union as a whole. It is then quite possible that under the new Treaty of Nice rules, the adoption of a common standard for corporate taxation could become one of the first example of an ECA in the EU. But if this ECA were successful, and companies all around Europe started to use this common accounting standard for their investment, any further country who wanted to join the ECA would be forced to accept to harmonize at this standard. Hence, there is a serious risk of future exploitation for the countries who decided not to join immediately this ECA.
To see these arguments more precisely, consider the following formalization of the above example. Suppose that there are only three countries, and that for historical reasons two of these countries have accounting and taxing standards for corporations that are closer than those of the third. To make this idea more precise, suppose that these historical standards can be represented as points on a line, with, say, country 1 having a standard equal to zero, country 3 having a standard equal to one, and country 2 having a standard in the interval between 0 and ½, so that there is a precise sense in which countries 1 and 2’s standards are “closer” than that of country 3. Also suppose that these historical standards can be changed, but at a cost, as legislation must be passed, lawyers, accountants and tax officials must be trained anew, errors in the transition periods must be corrected, and so on. Again for simplicity suppose that these harmonization costs can be represented by a quadratic cost function, so that one country has to pay a larger and increasing cost to harmonize, the further is the harmonized standard from its historical one. Harmonization of the standards between two or three countries may be beneficial because it may increase international capital mobility. But suppose, again following our previous argument, that there is some uncertainty about the actual benefits of a harmonization policy. For simplicity, suppose that there are only two periods, and that uncertainty disappears as time enfolds, so that in the second period there is perfect knowledge of the advantages from harmonization, while in the first period these advantages can only be assessed probabilistically. Let $P$ be the (first period) ex ante probability that harmonization may be beneficial for the federation. Our three-country federation has then a difficult decision to make in the first period.

It may decide to follow a *decentralization policy* in the first period (each country choosing a different standard), waiting until period 2 before deciding if it is worthwhile to go on with further harmonization. This would save the countries the costs of a harmonization policy in the first period, but at the risk of losing the benefits for harmonization in the same period (the increased capital mobility). Or it may decide to pay immediately the costs of full *centralization* (all countries agreeing on the same standard) in the first period, at the risk of wasting resources if harmonization would turn out not to be beneficial. Finally, a third possibility is to build an *Enhanced Cooperation Agreement* between countries 1 and 2 only in the first period (choosing the same standard for countries 1 and 2), so that at least these two countries can enjoy the benefits of increased capital mobility in the first period (in the case harmonization turns out to be beneficial), leaving to the second period any decision concerning the third country. Intuitively, this last option may dominate the other two, as countries 1 and 2’s historical standards are closer to start with, so that is certainly
less costly to implement a common standard between these two countries than it is to implement one for the Union as a whole. The catch, however, is what to do with the third country. If harmonization turns out to be beneficial (large returns for increased capital mobility as a result of corporate taxation harmonization), it may be advantageous for all countries to have the third country join the harmonization policy in the second period. But if a common standard has already been chosen between the two closer countries in the first period, the second period optimal harmonization standard for the Union as a whole may be further from the historical standard of the third country than it would have been had the ECA not been formed in the first period. As a result, the third country may turn out to be exploited in the second period by the first period ECA; that is, it may have to pay a larger cost to join the harmonization policy than it would do if the ECA had been prohibited to start with. Intuitively, which of the three policies, decentralization, centralization or ECA, is more desirable on efficiency grounds depends on several factors. The exogenous parameters of the problem (how large is \( P \) and how close are the historical standards of countries 1 and 2) on the one hand, but also on the governance rules inside the sub-union, and in particular on whether the “losers” from the different policies can be compensated by the “winners”.

To highlight these features, in Bordignon and Brusco (2003) we consider different possible scenarios. We start with the benchmark case in which a benevolent dictator (the European Commission?), equipped with lump sum transfers and subjected to unanimity voting by all countries, takes all decisions; we then introduce a number of more realistic political constraints into the analysis, up to discussing the “no veto-no exclusion” policy of the recent Treaty of Nice. Clearly, if a benevolent dictator is in charge of all decisions and can use lump sum transfers to compensate losers, all he has to do is to choose the harmonization policy which maximizes the sum of expected utilities of the three countries; at no efficiency costs, the lump sum transfers would then make sure that each country is better off with respect to the alternatives. Referring to Bordignon and Brusco (2003) for any analytical detail, figure 1 summarizes the results of the analysis for this benchmark case. In the picture, I measure on the vertical axis the expected utility of the federation (the summation of the three countries’ expected utilities) and on the horizontal axis the ex ante probability for the harmonization policy to be successful. The different lines in the picture represent the expected utility of the federation for each of the three different policies, in dependence of different values of \( P \). As drawn, all curves are increasing function of \( P \), but the expected utility of the federation in the three different cases is very different depending on the value of \( P \). For instance, when \( P \) is equal to zero (there is zero probability than the harmonization policy be beneficial), expected utility under centralization is certainly negative (all countries pay the cost of
harmonization to a common standard with no benefits), while, upon normalization, it is zero under decentralization (no country moves from his historical standard and so no harmonization cost is paid). On the contrary, when $P$ is one (harmonization is certainly beneficial) centralization certainly dominates decentralization, as in the former case countries enjoy for sure the benefits from harmonization even in the first period. Clearly, if one considers only centralization and decentralization as possible policies, there has to be an intermediate value for $P$, $P^*$, such that for $P$ smaller than $P^*$, decentralization dominates centralization in the first period, while for $P$ larger than $P^*$, centralization dominates decentralization in the same period.

LET US NOW ADD ENHANCED COOPERATION TO THE PICTURE. ECA IS CLEARLY AN INTERMEDIATE CASE; LOWER COSTS ARE PAID IN THE FIRST PERIOD (ONLY TWO COUNTRIES HARMONIZE THEIR STANDARDS), BUT ALSO LOWER BENEFITS CAN BE EXPECTED (CAPITAL MOBILITY INCREASES ONLY ACROSS THESE TWO COUNTRIES IN THE FIRST PERIOD). IN PARTICULAR, IT IS CLEAR THAT WHEN $P$ IS EQUAL TO ZERO, ENHANCED COOPERATION IS CERTAINLY DOMINATED BY DECENTRALIZATION (SOME COSTS ARE HOWEVER PAID IN THE FIRST PERIOD, WITH NO RESULTING BENEFITS), WHILE WHEN $P$ EQUALS TO ONE, ENHANCED COOPERATION IS CERTAINLY DOMINATED BY CENTRALIZATION (IF HARMONIZATION IS CERTAINLY BENEFICIAL FOR ALL, NO REASONS TO LIMIT IT ONLY TO TWO COUNTRIES). IF THERE EXISTS AN INTERVAL OF VALUES OF $P$ SUCH THAT ECA DOMINATES THE OTHER TWO POLICIES DEPENDS ON THE OTHER PARAMETERS OF THE PROBLEM. TO ILLUSTRATE, IN FIGURE 1, I DRAW TWO CURVES FOR THE EXPECTED UTILITY OF THE FEDERATION UNDER THE ECA POLICY, ECA1 AND ECA2. CLEARLY, IF THE CASE IS AS DRAWN IN ECA2, ENHANCED COOPERATION IS ALWAYS DOMINATED BY EITHER CENTRALIZATION OR DECENTRALIZATION, SO THAT THE EFFICIENT POLICY FOR THE FEDERATION WOULD MOVE FROM DECENTRALIZATION TO CENTRALIZATION AS $P$ INCREASES WITHOUT EVER CONSIDERING FORMING A SUB-UNION. ON THE CONTRARY, IF THE CASE IS AS DRAWN IN ECA1, THEN THERE IS AN INTERMEDIATE SET OF VALUES FOR $P$, $(P', P'')$, WHERE ENHANCED COOPERATION DOMINATES BOTH CENTRALIZATION AND DECENTRALIZATION. QUITE INTUITIVELY, IT CAN BE SHOWN THAT THE MAIN FACTOR DETERMINING WHICH OF THE TWO CASES IS MORE LIKELY TO OCCUR IS THE DISTANCE BETWEEN THE HISTORICAL STANDARDS OF COUNTRIES 1 AND 2. IF THIS DISTANCE IS VERY SMALL, THEN THE INTERVAL $(P', P'')$ IS CERTAINLY NOT EMPTY, WHILE IT MAY BE EMPTY IN THE OPPOSITE CASE (THAT IS, WITH COUNTRY 2’S HISTORICAL STANDARD CLOSE TO 1/2). PUTTING IT DIFFERENTLY, IF THE HETEROGENEITY OF THE UNION IS MUCH LARGER THAN THE HETEROGENEITY INSIDE THE SUB-UNION (THE STANDARDS OF COUNTRIES 1 AND 2 ARE MUCH CLOSER THAN THAT OF COUNTRY 3), THEN ENHANCED COOPERATION AGREEMENT MAY INDEED BE A GOOD IDEA, AS AN INTERMEDIATE STEP TOWARD FURTHER INTEGRATION. LEADING SUPPORT TO THE INSTITUTIONAL DEBATE
on ECAs in the EU, this indeed suggests that the efficiency case for sub-unions is the more robust, the more the Union is heterogeneous.

However, these results were obtained in the benchmark case where all decisions are taken by a benevolent dictator with full lump sum transfers at its disposal, hardly a realistic description of the functioning of the EU institutions. Suppose then now that lump sum transfers are no longer available. Indeed, there are no truly compensatory transfers across countries at work in the European Union; when one country is hurt by some decision, it is usually compensated by distorting other pieces of legislation, so in general inducing further welfare losses (e.g. Tabellini, 2002). For the time being, let us still suppose that countries can commit ex ante to harmonize at the efficient standard in the second period, meaning that the countries forming a sub-union can insure the third country that it will not be exploited in the second period if this country also turns out to join the ECA. Then, it can be shown that lack of transfers makes the case for ECA unambiguously better on efficiency grounds. The intuition is simple: decentralization does not require transfers, so that the expected utility of the federation in this case is unaffected by distorting transfers; centralization and enhanced cooperation may instead both require transfers, but because of the smaller variance of the standards inside the sub-unions, these transfers are certainly smaller for the ECA policy than for centralization, resulting in smaller welfare losses. In terms of figure 1, the line representing centralization would fall more than the line representing ECA, resulting in a larger interval for \((P', P'')\). That is, not only ECAs can be a good idea if the Union is made by very heterogeneous countries, it may be an even better idea if the Union finds it difficult or very costly to compensate “losers”, a situation which certainly characterizes the present state of the EU.

These are all good news for the ECAs’ arrangements. But again, all these results were obtained by assuming that the third country could be guaranteed against the fact the sub-union could generate future welfare losses. Suppose now, on the contrary, that countries can no longer commit on a particular harmonization policy, so that what happens in the first period may affect the standard of integration in the second period. Indeed, real world federations, including the EU, do not certainly work by committing on a particular contingent policy, but by committing on a particular decision making procedure. Suppose then, for simplicity, that in the second period decisions are still taken by a benevolent dictator, who, in the case that the harmonization policy proved to be beneficial, would naturally choose the harmonization standard so as to minimize the total costs for the federation. Suppose also that this decision maker can now pay lump-sum compensating transfers, so as to focus here only on the non-commitment issue. Then, it can be shown that the case for
decentralization and ECA unambiguously worsens under non-commitment. Centralization is not affected by non-commitment; if all countries agree immediately to a common standard in the first period, then that standard will also be obviously optimal in the second period, if harmonization proves to be beneficial. On the contrary, under both decentralization and ECA, countries have an incentive to choose their standards strategically in the first period, trying to affect the harmonization choice of the decision maker in the second period. In a Nash Equilibrium, the effect is then certainly a reduction in the expected utility of the federation under these two policies. In particular, it can be shown that the two countries forming a sub-union are able to exploit their first mover advantage, forcing the decision maker in the second period to propose harmonization at a standard which is closer to their historical standards and further from that of the third country. In terms of the figure 1, the result is then a downfall in both the lines representing decentralization and ECA, while centralization remains unaffected.

Summing up, then, on efficiency grounds, our theoretical analysis suggests that larger heterogeneity and lack of compensating transfers for losers makes the efficiency case for ECAs more robust; lack of commitment makes it instead weaker. The EU has neither compensating transfers nor commitment powers, so that the case for ECA remains largely undecided on theoretical grounds. But the analysis developed so far has remained fairly abstract; it may be instructive to see what happens if we introduce in our framework the arrangements for ECAs as agreed upon in Nice. As we remarked already, the Treaty of Nice has eliminated the veto power that the Amsterdam Treaty still gave to each country; at the same time, no country can be excluded by an ECA, once this has been formed. Furthermore, ECAs do not work following the decisions of a hypothetical benevolent dictator; in an ECA, the countries themselves decide about the policy of the sub-union either by unanimity or by qualified majority rule, depending on the subject covered by the ECA. For instance, in the case we are discussing here, corporate income taxation, choices inside the ECA would be taken according to unanimity ruling. Suppose then that starting from our theoretical framework, where the individual rationality constraint of each country had to be satisfied by the decision maker, we suddenly introduced the Nice rules, thus allowing countries 1 and 2 to go on with an ECA even against the wishes of the third country. What would then be the equilibrium effect on the Union harmonization policies?

Our analytical results unambiguously show that the effect is that of making immediate centralization, rather than Enhanced Cooperation, a more likely outcome. More precisely, the set of parameters under which centralization in the first period occurs under the “no veto – no
exclusion” rule of the Treaty of Nice, is larger than it would be if the individual rationality constraint of the third country had to be respected. Indeed, under the new ECAs rules in the Treaty of Nice, the third country is basically confronted with a “take it or leave it offer”; it may join immediately the sub-union and then have a saying on the sub-union harmonization policy, or it may enter (with some probability) later, and then, as the sub-union policy is determined by unanimity ruling, it has to accept to harmonize at the standard originally chosen by the two other countries. Putting it differently, the Nice rules have given to the willing countries a credible threat to go on with harmonization policy, forcing the more reluctant countries to follow immediately to avoid future exploitation, even if these may have preferred, and it may actually have been more efficient for the federation at large, to wait longer.

2.5 Policy implications

These results offer us some edge to discuss the present ECAs arrangements in the EU. On the one hand, our results certainly support the idea that ECAs may play an important efficiency role for an heterogeneous federation such as the EU. This role, in turn, is further reinforced by the lack of effective transfer mechanisms. Quite intuitively, if the Union is very heterogeneous and the countries who have more to lose by an integration policy on some issue cannot be compensated, or can only be compensated at very large welfare costs, it may be more convenient on efficiency grounds to give up complete harmonization altogether, and concentrate instead on subsets of countries which have more to gain from that particular integration policy and for whom compensatory transfers are less relevant. On the other hand, as the EU is unable to commit at particular integration policy, this policy may turn out to affect negatively the excluded countries in the future. Furthermore, the Treaty of Nice, by revoking the veto power still guaranteed by the Amsterdam Treaty to each EU member, has radically changed the rules of the game, making it possible for a (substantial) group of EU countries to go on with integration even against the wishes of the remaining countries. Which kind of insights these arguments offer on the present ECA’s arrangements, both on positive and normative grounds?

On positive grounds, they may first of all help us understanding why some countries in the past have opposed the formation of sub-unions by other EU countries, even without (obvious) negative externalities being at play. Perhaps, these opposing countries were not concerned about present or future externalities; they were concerned about the risk that a sub-union today would have made it more difficult for them to harmonize at that issue in the future at terms they would have found acceptable. Second, these insights may also explain why the current arrangements for ECAs in the
EU still attempt to offer some decision role on the sub-union policy to the excluded countries (through the EU Commission and the EU Parliament), although it can be doubted that this role is completely satisfactory, a point on which we return below. Third, they may also help us explaining other puzzling aspects of the present EU institutions.

For example, several observers have questioned the presence of the UK in the Ecofin, as this Council is in charge of deciding the sanctions for the EMU countries who fail the Maastricht rules, while the UK is not at the present a member of the EMU. And indeed, if one simply thinks in terms of present negative externality, this presence makes very little sense. What would be the negative externality for the UK of, say, France running a 4% current deficit over GDP instead than a 3% deficit as prescribed by the Maastricht rules? The UK role however acquires a very different meaning if one thinks dynamically, as suggested by our own analysis. Maybe the UK is in the Ecofin, and it should be there, because what the UK is really doing in the Ecofin it is to defend its stake for the future. Should the UK decide to join the EMU in the future, it has an obvious interest that this monetary union satisfies a number of desirable characteristics, including financial stability, and this can be better guaranteed by helping the current EMU countries to adhere to the Maastricht rules.

Four, our analysis also helps putting in evidence other unexpected features of the current ECAs arrangements. For example, as our formal analysis proved, the main effect of the introduction of the Treaty of Nice rules for ECAs in the EU may be not that of increasing sub-union formation, but that of increasing straightforward centralization. That is, the present ECAs arrangements may simply be a device to force reluctant countries to accept more integration. Indeed, many observers have argued that the poor decision making rules agreed upon in the Treaty of Nice have been the result of a deliberate attempt made by a number of countries to stop the European integration process altogether, by making it more difficult for the Council to reach decisions. If this is the case, then the European Commission, who was the great sponsor of revoking the veto power for ECAs in the Treaty of Nice, may have actually managed to outsmart these countries. What these countries have failed to realize, it is that the current ECAs rules offers a powerful weapon for the European Commission to force integration on reluctant countries, by threatening them of future exploitation if they do not accept integration immediately.

This takes us directly to the normative side of the analysis. No doubt that ECAs can be beneficial if more centralization is efficient on a particular policy domain, but the inability to make
compensating transfers does not allow this efficient outcome to arise. Moreover, it is also interesting that, as we point out, that ECAs can be beneficial even though their formation is not part of the equilibrium, as the threat of their formation is sufficient to generate the enactment of EU-wide policies. But the interests of the outside countries must also be taken in consideration, As argued above, the current ECAs rules consider a number of devices to defend these interests. However, these arrangements seem hardly to be enough. The European Parliament is largely powerless, and it is further quite likely that a coalition of countries who managed to have a sub-union approved via qualified majority rule in the Council would also find the numbers to have the ECA policy approved by the Parliament, where the decision rule is simple majority. The naive idea that leaving excluded countries always free to join the sub-union subsequently is enough to protect them from exploitation is simply wrong. As we remarked above, countries who join the sub-unions subsequently of their formation are required to comply with the decisions already taken; and although the decision rules inside the sub-union may also contemplate qualified majority ruling and not only unanimity as in our formal example above, it is difficult to believe that new entrants could easily revert decisions already taken\textsuperscript{12}. To repeat a point already made, policies and institutions have their own hystereses; in all cases, you do not go back easily from decisions already implemented. This supports our previous claim that is above all the European Commission who has been given by the Treaty of Nice rules the role of a guarantor of the interests of all EU members, both inside and outside the sub-union. By deciding if the sub-union is acceptable, by drafting the proposal for the Council and by deciding ex-post who can join the sub-union, the European Commission is the key player in the current ECAs arrangements.

This is not necessarily a bad thing; indeed, the Commission has proved in the past to be able to play the role of a super-party (or better super-country) institution. But even leaving aside the fact that this may not happen in the future, the Commission, as an institution, has an in-built mission towards more and more centralization among the EU countries. There is then a serious risk that the Commission may use the new ECAs tools to pursue excessive and unnecessary centralization. At very least, it is important to be aware of this risk as this may suggest countermeasures or may help avoiding mistakes. For example, from this point of view, it is clearly not a very good idea to reduce the number of countries inside the EU Commission, as advocated by the Convention and agreed in the Intergovernmental Conference of June 2004, as this weakens the impartial nature of the main institution which now protects excluded countries.
Finally, it should also be noted that the efficiency role for ECAs is strengthened by the lack of effective compensatory transfers across EU countries. Should these transfers be in place, there would certainly be less need of ECAs, as countries could more easily agree on adopting a common policy if they could compensate the losers. Surely, the introduction of effective compensatory transfers across the EU countries would raise difficult political and economic issues, ranging from asymmetric information problems to the deadweight losses of transfers. But a lot could be done to improve upon the actual transfer mechanisms, which in reality compensate countries by fictionally performing other roles, as is the case for the structural regional funds or for the CAP system for agriculture. Thus, this paper certainly speaks in favor of substituting this highly imperfect transfer system with more explicit cross-countries compensatory mechanisms.

3. The allocation of powers inside the EU and the “open coordination method”

3.1 The problem
One of the most fundamental questions in the theory of fiscal federalism concerns the correct allocation of functions to the different levels of government. In the context of the European Union, this means asking which functions should be advocated by the Union itself, and which functions should instead remain at the level of the member countries. The Convention has made an effort to streamline the attribution of functions to the different levels of government in the Union, differentiating these competencies in three broadly sectors, exclusive competencies of the Union, concurrent competencies, and exclusive competencies of the countries. This categorization has however left the preceding distribution of powers across the two levels of government largely unchanged. Many observers claim that this distribution is inefficient and should be changed. Economists may have some suggestions to offer. According to Oates’s (1972) celebrated decentralization theorem, for example, functions with more (less) spillovers effect and less (more) heterogeneity of preferences across jurisdictions should be centralized (decentralized). In its simplicity, this is a recipe which can carry one some way. For example, Alesina et al. (2001) do use this framework to assess the optimality of power assignments inside the EU (see also Stehn, 2002 and Inman and Rubinfield, 1997 for exercises along the same lines). But, as we remarked already, the central government in the case of the EU has not the same powers or the same characteristics of a central government in a federal state, making it problematic to apply the Oates’s argument to the EU. Furthermore, another important limitation of Oates’s analysis is that he assumes welfare maximizing governments. It is not entirely clear how far his insights could go in more realistic
political environments. Unfortunately, these environments are exactly those where the debate toward more or less centralization at the European level is actually taking place.

In particular, while the situation about the demand side (monetary and fiscal policies) is more or less settled, there is an on going debate on the role that the EU institutions should play on the supply side, in fields such as labor markets institutions, competition and regulation policy, education, pensions and environment (see, for instance, the Sapir Report, 2003). These are policy dimensions where the current assignment of functions give the members countries most of the decision power (except, to some extent, for competition policy and environment). However, the EU has taken some steps towards some loose form of coordination among these national policies. Under the Lisbon agreement, the so called “open method of co-ordination” calls for peer review on these policies by the member countries, with the aim to try to promote the best practices across the EU countries. Here, the EU institutions can not force the member countries to follow any particular policy; at most, they can only suggest the adoption of a particular policy. Many believe that this is not enough and that a larger role should be given to the Union (e.g. Sapir, 2003); others, instead, feel that this could only be counterproductive, reducing beneficial competition across the EU countries (e.g. Tabellini and Wyplosz, 2004). In all cases, the “open method of co-ordination” is a strange combination when looked from the perspective of traditional fiscal federalism theory. This theory usually advocates for a clear-cut assignment of functions to the different levels of governments, while the open method of co-ordination is an example where the competencies of the Union and the member countries somewhat overlap.

To cast light on this debate, Oates’s decentralization theorem is of very little use. National policies on these supply side dimensions clearly induce some spillovers effects across countries, but they do not seem to be so relevant to call for immediate harmonization (as is the case, say, for the common market). On the other hand, due to historical and cultural reasons, there is possibly some heterogeneity in national preferences across these fields, but they do not seem to be so relevant to call for complete decentralization (except perhaps, in the case of education). Most importantly, these are also those dimensions where the assumption that national governments choose their policies to maximize national welfare seems to be more widely off the mark. Indeed, most observers would agree that the policies chosen in these fields are largely influenced by the pressure imposed by powerful organized national interests' groups on national governments; trade-unions in the labor markets, pensioners in the pension system, firms in the regulation and competition policy, professors in the education system and so on (e.g. Tabellini and Wyplosz, 2004). The important
policy question, over which theoretical analysis should attempt to cast some light, would then seem to be whether these pressures are likely to become more or less powerful once these functions were centralized at the EU level.

Unfortunately, the theoretical literature is of very little help on this particular issue. The recent attempts to extend Oates's analysis to a political economic framework (Besley and Coate, 2003; Lockwood, 2002; Seabright, 1996), while largely confirming Oates’s intuitions, do not consider the effect of pressure groups on politics. On the other hand, while there is a very large economic literature on lobbying (e.g. Grossman and Helpman, 2001), very few studies have concentrated on the specific issue of the relationship between interest groups and decentralization. Furthermore, when they have done so, they have only focused on the higher heterogeneity of preferences under centralization as the main discriminating factor for lobbies’ formation and influence (e.g. Redoano 2002). But, as argued above, difference of preferences across European countries hardly seems to be the crucial issue in the present context.

More policy oriented economists seem to have more clear-cut opinions. For example, in a very influential policy paper written for the World Bank, Prud'homme (1994) severely warned against "the dangers of decentralization", the main danger exactly being the (presumed) stronger influence of local interest groups on local governments. Prud'homme's main argument has nothing to do with preferences heterogeneity. It relies instead on a greater natural "disposition" by local governments to "accept" pressures from local interests, presumably due to the fact that supporting a local interest may generate additional benefits for local politicians than supporting an external one, in terms, say, of political consensus. This is the same idea which continuously surfaces in the political debate on decentralization inside countries and even concerning the proposals of harmonization in the EU context.

Is this idea correct? If the answer is yes, then maybe there are politically motivated reasons, additional to those considered by Oates’s theorem for, say, supporting centralization at the EU level in the above mentioned fields. If the answer is not, however, then maybe there are additional, politically motivated, reasons to maintain these functions at the level of member states.

3.2 The analysis

To discuss this issue, in Bordignon, Colombo and Galmarini (2004), we build a simple model of lobbying behavior. In this model there are two identical regions, and in each region, there are two
private goods and one regional public good. One private good is the numeraire (and the only factor of production) and it is sold in a competitive market; the other private good is instead produced by a resident firm (wholly owned by residents of the same region) and, if allowed by governments, it is sold both at home and in the other region. When both of these firms operate in both regional markets, the two firms compete a la Cournot in each regional market; otherwise, there is a monopoly in each market. Each regional public good is complementary in consumption to the private good produced by the two firms, meaning that the two firms could gain by an expansion in the production of the regional public good. Finally, the regional public good is financed by resident taxation on local consumers (including firm’s profits), so as to avoid tax competition effects. For simplicity, and because they do not appear particular relevant in the EU context, in the model we abstract entirely from differences in preferences, mobility of individuals, and intergovernmental transfers.

In the paper, we consider two polar cases of decision making, a *full centralization* case where a central government decides the number of firms allowed to operate in each market and public good supply in each region; and a *full decentralization* case where both decisions are taken by the local governments. The crucial difference between centralization and decentralization is that in the former case, the central government internalizes as components of social welfare the profits that both national firms make in both markets; on the contrary, in the latter case, the local government is only interested by the profits made everywhere by its own resident firm. This is the simplest way to capture into the model Prud’homme’s main idea that local politicians may care more for local interests than for foreign ones.

In this model, regional firms have an incentive to lobby the governments, either for expanding local public good production, or for gaining access to the regional market, as both policies would increase their profits. In particular, we consider two polar cases of lobbying. The first, which we call *lobbying in the market*, is the case when both national firms are already operating in both markets. Note that in this case, the two firms have a *common interest* in lobbying the governments to increase regional public good supply in both regions. The second, which we call *lobbying for the market*, is the case where firms are not yet operating in the market and have a *conflicting interest* to be the only one to operate in each market, as this could earn them monopoly profits.

We model lobbying using the common agency approach developed by Bernheim and Whiston, 1982 and popularized by Dixit et al. (1997). According to this approach, under lobbying behaviour,
governments maximize a weighted social welfare function giving weight \((u)\) to social welfare (the sum of consumers and producers surplus, as perceived by the different types of government) and weight \((1-u)\) to lobbies’ contributions, where \(0<u<1\) measures the “honesty” of the government. This is clearly a “reduced form” of some (un-modeled) more complex political environment. Politicians are interested in social welfare either because they are benevolent or just because they want to be re-elected; but they are also interested in firms’ money because this may increase their chances of re-election (contribution campaigns) or may increase their private consumption. Thus, in the centralization case, we have two principals (the two firms) who lobby a single agent (the central government) either for gaining access to the market or for increased regional public good supply; vice-versa, in the decentralization case, we have two principals (the two firms) who lobby two agents (the regional governments) for the same policies. This is a more complicated case of lobbying than the simple common agency approach, a case of a “game played through agents” also more formally studied by Prat and Rustichini (2003).

The crucial question raised in the paper concerns the effect of lobbying in the different cases. In particular, when is lobbying more damaging for social welfare, under centralization or under decentralization? And for which of the two policies, access to the market or public good provision?

3.3. Results

The analysis shows that the answer crucially depends on the characteristics of the policy being lobbied. When lobbying is in the market, decentralization turns out to be unambiguously better for social welfare than centralization. In this case, under centralization, both firms always lobby for both regional public goods, public goods are distorted upward and the resulting equilibrium is Pareto efficient; under decentralization, vice-versa, there are equilibria where both firms lobby both local governments as under centralization, but in this case lobbies need to pay more (earn less profits) to induce the same distortion. Furthermore, under decentralization, depending on market structure, there also equilibria where lobbies only lobby one local government at the time (often the foreign one), public good supply is less distorted and some of these equilibria are Pareto inefficient, which in our case is good news as it means that lobbying is less effective.

On the contrary, when lobbying is for the market, centralization turns out to be unambiguously better for social welfare than decentralization. In this case, under decentralization, the local firm always outbids the foreign one; in equilibrium, there is then always a local monopoly in each market (each resident firm always serves his own regional market only) even if a duopoly would be more efficient. Under centralization, on the contrary, the central government is more often prepared
to allow both firms in the market (that is, there is a no empty set of parameters where this happens in equilibrium). These different results depend on the fact that under decentralization, differently from centralization, the local government is only interested on the profits of the local firm, and this gives the latter an easy way to outbid the foreign firm. Interestingly, in the lobbying for the market case, we also show that a different regime of split competencies (where the central government decides about who enters, while the local government decides about public good supply) often dominates both centralization and decentralization. This is so because this last regime reduces the rents that a dishonest policy-maker can exert from firms when offering them monopoly powers in the markets, and this forces the policy-maker to take more often the efficient choices.

The main intuition behind these results is simple. When the interests of national lobbies are aligned, as is in the case of lobbying in the market, decentralization makes it more difficult for the national lobbies to coordinate their actions; and however, they have to pay more to convince the local government to internalize even the other firms’ profits. Hence, decentralization is unambiguously better than centralization, and lobbying is less important and less distorsive. Vice-versa, when the interests of national lobbies are in conflict, as is in the case of lobbying for the market, local governments are more easily captured by local interests, as correctly suggested by Prud’homme. Hence, centralization is unambiguously better than decentralization.

Clearly, this analysis cries for extensions. In particular, for the sake of simplicity, we eliminated any form of external effects (spillovers effects in public good productions, mobility of firms across regions induced by fiscal policies etc.). But clearly these may be important even as lobbying is concerned. For example, while in the traditional theory the presence of spillovers, whether positive or negative, is always an argument for more centralization, one could conjecture that their effects should be different once lobbying behaviour is taken into account. In the presence of negative spillovers, lobbies are more likely to have conflicting interests, while when there are positive spillovers, lobbies’ interests are more likely to be aligned. Hence, our analysis would suggest to move more towards centralization when externalities are negative and towards decentralization when they are positive.

3.4 Policy implications for the EU

This analysis then suggests that the answer to the question if it is better centralizing or not a particular policy when lobbying behavior is likely to be important, crucially depends on how the
interests of national lobbies are positioned with respect to that particular policy. If the national lobbies have common interests on that policy, then it is better to decentralize, as decentralization induces a sort of competition across lobbies when there is none; on the other hand, if national lobbies have conflicting interests, then it is better to centralize, as local governments are more easily captured by local interests. Going back to the EU debate, one notes that in fields such as consumer and environment protection, foreign and domestic producers would have the same interest to lobby for low consumers' protection if this policy were decided at the EU level. They would do the same if policy remained at local level, of course, but then each country would have no interest to internalize the effects of low consumers' protection on the profits of foreign firms, leading to lower distortions. Ceteris paribus, then, our argument would suggest not centralizing these functions. Vice-versa, in fields such as production subsidies to national producers, protection of market share of incumbents and "national champions", national lobbies have conflicting interests, and centralization at the EU level would force the policy maker to take into account also the interests hurt by the protection policy. Hence, ceteris paribus, our argument would suggest to centralize these functions. Finally, in the latter case, our argument also suggests that a policy of “split competencies” may often be superior on efficiency terms to either centralization or decentralization, because it induces a sort of competition between the different levels of government which makes them more resilient to lobbying. While this result clearly needs further enquiries, it is worth stressing. We derive concurrent competencies as the optimal institutional solution to a political constraint (the presence of lobbying). This is in contrast with received fiscal federalism theory, which sees overlapping competencies as inefficient institutional arrangements. As concurrent competencies are instead often observed in existing federations, besides the EU, one then wonders if lobbying might not provide a possible rationale for these arrangements. In the EU case, our result clearly leads support to some form of concurrent competencies between the Union and the member states, as we observe, for instance, in the “open method of co-ordination” case.

4. Concluding remarks

The European Union has some very special characteristics. It is less than a federal state and it is more than an economic union; it follows that in assessing its institutions, the knowledge accumulated on other federations or economic unions is often of limited use. In particular, the economic theory of fiscal federalism, developed for different institutional contexts, needs to be seriously amended when applied to the EU. In order to offer relevant policy advice, economists need to make a serious effort to understand first the functioning of the EU peculiar institutions. The
previous analysis has offered some examples on how one could proceed. The traditional economic recipe about the optimal assignment of functions to different level of government makes little sense when the central government has the peculiar characteristics and decision making rules of the EU institutions. Furthermore, in the presence of relevant lobbying behavior, one must also understand how centralization and decentralization would change the political incentives of the different levels of government. The analysis of sub-union formation and governance inside the EU raises subtle theoretical and policy issues, which can only be appreciated by putting them into the context of the functioning of the other institutions of the Union. Dynamic considerations and the strategic behavior of the actors involved reveal unexpected consequences of the existing rules for ECAs, leading one to question their optimality.

However, this is only the tip of the iceberg. There are several other fields which would require careful enquiry. The precise relationship between the different decision making bodies of the Union, the Commission, the Parliament and the Council, for example, rests largely unexplored on both theoretical and empirical grounds (for a preliminary analysis, see Noury et al., 2003); the issue of which taxing powers should be given to the Union, if any, is still little discussed in the literature; the problem of the implementation of the economic policy of the Union, lacking executive powers by the center, is still an unsolved and interesting element for the analysis. Economic theorizing, and in particular the economic literature on the relationship between different levels of government, could offer an important contribution for a better understanding of these features. But for this contribution to be successful an effort must be made to ground the analysis into the actual functioning of the EU institutions, rather than pretending of applying directly received theory to a completely different context.
References


Redoano, M., 2002, "Does centralization affect the number and size of lobbies?" mimeo, University of Warwick.


Figure 1. Enhanced cooperation, centralization and decentralization

Expected utility of federation

Decentralization

Centralization

ECA1

ECA2

P''
P*
P'
More precisely, the President of the European Commission, appointed by the Council, needs a confidence vote by the majority of the European Parliament to be confirmed. However, the acts of the Commission do not need a majority of the Parliament and the Commission can only be dismissed by the European Parliament with the votes of 2/3 of its members. See Berglof et al. (2003) for further details.

Indeed, as a referee suggested, this can be taken as an example of the “theory of second best” as applied to institutional design. One always needs to look at the details of the institutional environment, since a specific rule which may appear meaningless at first glance may prove to be a beneficial response to another rule or to an “institutional incompleteness” once that the entire picture is taken into account.

See Bordignon and Brusco, 2004, and Bordignon and al., 2003.

Dewatripont et al.’s analysis could be interpreted as an application of the standard theory of customs union to ECA’s: if forming a sub-union is efficient or not, it boils down on whether “trade creation” or “trade diversion” type-effects dominate.

See also Widgrén (2001) for an analysis of voting behaviour inside the ECA, in the case the policy in the ECA is determined by majority rule, and Perotti (2001) for a discussion of a case where policy harmonisation inside the EU would actually be harmful.

Our point here, as it is based on lack of commitment at the political level, is obviously strictly linked to the “incomplete contracts” literature; see, for instance, Bolton and Whinston (1993).

This implies that we do not consider here the advantages of learning which can come out from the ECA; whether the countries form an ECA in the first period or not, uncertainty dissolves in the second period. But the model could easily be extended to consider this feature too, by making the degree of uncertainty in the second period depending on the fact if an enhanced cooperation or centralization policy has taken place in the first period. Notice that while this may make the case for ECA more robust on efficiency grounds, it would not change the basic trade-off we focus on here.

The curves representing expected utilities are drawn as linear as an illustration only; in reality, except for the centralization case, they are all not linear functions of $P$. But it can be shown that they intersect only once, so that the picture correctly captures the main intuition of the results.

Expected utility under decentralization increases with $P$, because with a quadratic cost function, each country prefers to move a bit its standard in the first period, even if no harmonization occurs in that period, in anticipation of the possible move toward full harmonization in the second period.

Strictly speaking, these inequalities depend on the assumptions made on the technology parameters; see again Bordignon and Brusco (2003) for details.

What we show in Bordignon and Brusco (2003) is that with quadratic cost functions ECA never requires transfers, so that also the ECA line would remain unchanged. This may not be true for other cost functions, though, although the general intuition discussed in the main text would still remain valid.

In reality, the presence of qualified majority ruling for ECAs arrangements would create more complex strategic behaviour on the part of the countries joining the sub-union, as there would be the possibility of majority reversals in the sub-union in the future, if other countries also turned out to join the sub-union (along the lines, for instance, of the work by Fernandez and Rodrick, 1991). The more extreme countries forming the sub-union at the outset would probably search for compensation, asking for an integration closer to their standard so as to make majority reversal more difficult. These issues are briefly touched in Bordignon and Brusco (2003).

I owe this point to an anonymous referee.