2 ASSIGNING RESPONSIBILITIES IN A FEDERAL SYSTEM

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Introduction

In 1777, the thirteen newly independent states of America drew up the Articles of Confederation. Article III set out the purposes of this 'firm league of friendship' – 'for their common defence, the security of their liberties, and their mutual and general welfare'. Ten years later, the same language appeared in the Constitution of the United States, which aimed to 'establish Justice, insure domestic Tranquility, provide for the common defence, promote the general Welfare, and secure the Blessings of Liberty …' Section 8 of the first Article lists the delegated powers that were considered necessary for these purposes, including the power to collect taxes (in proportion to the population of each state) in order to regulate commerce between the states and with foreign nations; to borrow and coin money; to establish post offices and post roads; to introduce patent protection and copyright 'to promote the progress of science and the useful arts'; and to conduct foreign affairs, including the support of military forces.

Two hundred and twenty years later, the Treaty of Lisbon sets out a more detailed list of 'competences' for an EU. As in the case of the US Constitution (which replaced the Articles of Confederation in 1789), the powers are 'governed by the principle of conferral'[1] and (echoing the tenth amendment of 1791) 'competences not

1 Title, 1, Article 5(1) 'Consolidated Treaties'.

conferred upon the Union in the Treaties remain with the Member States'.[2] In other words, the individual states are regarded as conferring upon the Union certain specific delegated powers, while retaining for themselves an open and unspecified list of remaining competences. Exclusive competence[3] is granted to the Union in the areas of the customs union, the rules governing the internal market, the common commercial policy, monetary policy for members of the euro area and the common fisheries policy. With the exception of the latter, these correlate with the commerce and monetary clauses of the US Constitution. In addition to these exclusive competences, there is a class of 'shared competence'[4] in which both individual states and the Union as a whole can act. This class includes areas such as (inter alia) some aspects of social policy, agriculture, the environment, consumer protection, transport, energy, safety and public health matters. The Union may also act in research, technological development and humanitarian aid and may 'support, coordinate or supplement' the actions of member states in human health, industry, culture, tourism, education, sport, training and civil protection.[5]

This extensive list of exclusive and shared competences naturally gives rise to the question of what principles, if any, lie behind it. When would we expect to see individual states finding it advantageous to enter a federation with powers to impose rules binding for all its members, and when would we expect a state to remain aloof? Does economics provide any tools for identifying the circumstances in which leaving states to make unilateral decisions will produce generally superior outcomes (defined by various possible normative criteria) to joint decisions? If joint decisions are potentially beneficial, what decision rules should be adopted?

2 Title, 1, Articles 4(1) and 5(2) 'Consolidated Treaties'.

3 Part 1, Title 1, Article 3, Treaty on the Functioning of the European Union.

4 Part 1, Title 1, Article 4, Treaty on the Functioning of the European Union.

5 Part 1, Title 1, Article 6, Treaty on the Functioning of the European Union.

It is immediately evident that such questions are the province of 'political economy' broadly conceived rather than of standard microeconomics. States are themselves made up of many people with differing interests, so identifying some form of coherent collective interest for each one presents problems of its own. Furthermore, when collective decisions are made, questions of legitimacy arise that are not entirely a matter of rational analysis (which is not to say that the legitimacy of a collective process is unrelated to its ability to serve the rational interests of its participants). Institutions that are familiar, with long historical roots, have a quite reasonable pull on human affections (as any follower of Edmund Burke would argue) and may have qualities for coping with very complex circumstances that purely rationalistic models cannot uncover. Nevertheless, public finance and institutional economics do provide a conceptual apparatus that permits some discussion of the problem of the assignment of competences between layers of government.

Public goods and interjurisdictional spillovers

Public goods

A convenient starting point for a discussion of how competences are assigned between levels of government is the idea that one of the state's basic roles is the provision of public goods. Hume (1740) gave the example of draining land, something that might involve thousands of people in a collective endeavour, the benefits of which would be experienced in common. Each individual would have an incentive to avoid paying and to free ride on the efforts of others, so securing agreement and organising the work would be very difficult, if not impossible. Political society is the solution to this public goods problem – forcing citizens to pay through the tax mechanism and, in democratic states, inducing them (imperfectly) to reveal their preferences in a voting process.

Indeed, defence against foreign invasion as well as protection from violence and the provision of security and justice at home are the classical public goods and underlie the economic theory of the state (Baumol 1952).

In the case of pure public goods, all individual people experience the same level of service, and an increase in the population would not cause any reduction in its quality. A larger state in the sense of a bigger population of taxpayers is clearly advantageous in that a given level of public good supply can be achieved at a lower cost per taxpayer. Similarly, there would be an advantage to extending the state by means of joining a federation for the purposes of producing this pure kind of public good. A standard argument, therefore, is that we would expect federal jurisdiction over public goods that have a range that spans the full geographical extent of a federation.

This classical conception is clearly reflected in the US Constitution, which emphasises 'common defence', specifically empowers the US to raise armies and maintain a navy, and forbids to the states the power of making treaties or forming alliances.[6] In contrast, the consolidated treaties of the EU reflect an awareness of the lack of a sufficiently developed sense of common European interest. There is an aspiration 'to define and implement a common foreign and security policy, including the progressive framing of a common defence policy'.[7] This, however, must be seen in the context of a clear statement that 'the essential state functions' of 'ensuring territorial integrity, maintaining law and order and safeguarding national security' are respected by the Union. 'In particular, national security remains the sole responsibility of each Member State'.[8] A common defence will occur only 'when the European Council, acting unanimously, so decides'.[9]

6 US Constitution, Article I, Sections 8 and 10.

7 Part 1, Title 1, Article 2(4), Treaty on the Functioning of the European Union.

8 Title 1, Article 4(2) 'Consolidated Treaties'.

9 Title V, Chapter 2, Article 42(2) 'Consolidated Treaties'.

It seems, therefore, that even the case of defence is more complicated than its simplistic classification as a federal public good would suggest. In the first place, any more realistic assessment of defence as a collective good might begin to question the degree of purity that is generally involved. As a federation expands to incorporate more states within its territory, it is not obvious that the new members simply lower the price per unit rather than impose new defence requirements. Neither is it obvious that all states would necessarily consider themselves equally defended by the forces of the federation. Different states might face differing threats requiring differing diplomatic, technical and military responses. If a particular state of a Union suspects that the Union is likely to be unreliable in defence of the state's interests, or to put a relatively low priority on its security concerns, it would be expected to prefer to preserve a significant level of local control over defence expenditure in spite of the possible economies that could in principle be realised through integration.

Regional and local public goods

If public goods usually depart considerably from the non-rivalness condition of the pure case, it is also true that the geographical range of the benefits conferred by a public good can be restricted. Indeed, the case for 'fiscal federalism' and the existence of devolved governments with powers to determine public goods provision has traditionally depended on local public goods. Street lights confer benefits on passing travellers, no doubt, but primarily they benefit those who live in a given neighbourhood. Flood defences will depend upon the management of particular water courses and will not be of such concern to those who live away from a flood plain. Police forces will often face rather different problems in different cities or regions. There is a strong case here for devolved decision-making on the grounds that local preferences will vary and that knowledge of particular local circumstances will be more

likely to influence decisions. Central decisions that impose standard levels of local or even national public goods provision across a federation will not reflect differences in social costs and benefits. They are thus less likely to be efficient in the sense of maximising the possible net social gains available.

Where the mobility of a population between the states in a federation is considerable, and where cultural and linguistic barriers are low, the case for more centralised intervention in the provision of local public goods can be made on the grounds that potential migrants might be prepared to pay for better services. Those who might seek employment or retirement opportunities in neighbouring states could be considered to have an interest in the standards of public services available there, which the federal jurisdiction represents. The introduction of minimum centrally determined standards can then be seen as a (somewhat crude) response to this problem and a way of taking account of the option value of the local services to residents of other states. More commonly, Federal intervention is justified on the grounds of reducing regional disparities of income or wealth; hence the resulting disparities in the ability to finance public goods. If income distribution were the principal concern, then lump sum transfers to poorer states would be predicted – or indeed income transfers to poorer individuals irrespective of state residence. However, interstate fiscal transfers are often earmarked for specific purposes or take the form of matching grants, which suggests that relaxing the constraint of the local tax base is not the main consideration. The matching grants are also supposed to allow for interjurisdictional spillovers in specific areas, and they are therefore a centralised response to a perceived efficiency problem.

Interjurisdictional spillovers

The idea that interjurisdictional spillovers must inevitably buttress the case for greater centralised (federal-level) collective

decision-making is a conclusion that seems to arise naturally from the textbook analysis of market failure and public policy. If central decision makers are informed and benevolent, they will take into account the existence of beneficial or harmful spillovers, and the associated activities will be suitably increased or curtailed. Disinterested and well-informed federal public officials would implement optimal policies. In practice, however, the required information on the preferences of the people affected and the technical opportunities available for mitigating external harm or for taking advantage of spillover benefits will not necessarily be available. Collective decision processes at the centre may reflect the interests of powerful pressure groups or the influence of states that are only very distantly affected.

Institutionally, the situation is analogous to the problem of whether firms should merge to take advantage of mutual spillovers or whether the potential gains can be achieved through contract. As is well known, relatively high transactions costs in the market will favour merger and internal governance, while, conversely, relatively high costs of incentive and control within the firm will favour a contractual solution. If we can regard individual states as equivalent to firms, the choice between growth through merger and growth through the extension of market contracts is mirrored in the state's choice of accession to a federation and the extension of individual treaty arrangements. Just as bee-keepers and apple growers might decide to merge their operations in order to internalise the mutual external benefits that each confers on the other, states might similarly opt for joint decision-making when close, mutual interdependence is the norm. However, some external effects might be relatively straightforward to handle through market contract, in the case of firms, or international treaty, in the case of states.

The important point to note here is that the case for the assignment of a particular competence to a particular level of government cannot be regarded as a matter entirely determined

by the existence and extent of spillovers. The important matter is the more complex one of determining the relative bargaining costs, agency costs and effectiveness of different collective decision-making processes. Decisions in the EU made by qualified majority, for example, are capable of imposing high costs on a dissenting state. However, a unanimity rule (required in some areas) might be expected greatly to increase bargaining costs and to reduce the chances of achieving many potentially advantageous agreements. Each state has to determine whether the cost of unwelcome legislation is or is not outweighed by the benefits of Europe-wide agreements that would otherwise not be achievable.

Competition between jurisdictions

The discussion thus far has concerned the dilemmas that arise when public goods and interstate spillovers give rise to possible gains from cooperation, and states confront the choice of entering formal Union or federal mechanisms to resolve these problems or to remain outside and negotiate treaties on a state-to-state basis. The only general conclusion that can be derived is that the more interdependent the states (the more 'pure' a public good) and the greater the number of states involved (the higher the costs of bargaining), the more potentially advantageous a federal competency in the area will be. Even here, however, reinforced majorities will be required to reassure states that collective outcomes will not result in net losses if interstate income levels or preferences differ greatly. Local public goods, in contrast, are more likely to be allocated efficiently by lower level governments.

The final statement of the previous paragraph has so far been justified by reference to better local information, but it has by no means been fully demonstrated. The median voter theorem is often invoked to predict the provision of local public goods,

but this is not guaranteed to be efficient.[10] Furthermore, where voting involves choice over packages of policies rather than single issues, or where powerful local interests (political and bureaucratic) play a decisive role, local collective choices will be distorted, and the greater efficiency of local outcomes is hardly assured. What is required is some mechanism for forcing voters to reveal their valuations of local public goods and for taming the power of local interest groups.

It was Tiebout (1956) who first advanced the idea that the migration of population between jurisdictions could be seen as a decentralised market mechanism for introducing competition and revealing people's willingness to pay for local public goods. A person who regarded an existing level of provision as either excessive or inadequate (at the prevailing tax price in the relevant community) could simply move to another jurisdiction that matched his or her preferences more accurately. In this way, the residents of a jurisdiction become consumers exercising their choice over tax and public goods packages. The classical 'revelation of preferences' problem in the case of public goods is circumvented because the goods are local and consumption requires the voluntary decision to locate at a certain place and pay the tax price. The ability to 'exit' and purchase elsewhere makes the situation comparable to the decision to join a club or purchase any jointly consumed service where exclusion is possible.

The conditions required for this process to work perfectly (in the sense of ensuring the ideal provision of local public goods across jurisdictions) turn out to be extremely demanding. People must be able to set up any number of new jurisdictions, mobility costs must be zero and there is should be a single local public good. With a fixed number of communities, heterogeneous individuals and multiple local public goods, it is not surprising

10 The median voter theorem is extensively discussed in public choice theory: see Mueller (2003).

that the Tiebout process cannot be relied upon to ensure an allocation of resources that is efficient (see, for example, Atkinson and Stiglitz 1980: 519–56). Nevertheless, the existence of mobile resources will limit the ability of a local political process to generate results that are massively inefficient or exploitative. From the point of view of the implementation of optimal policy by fully informed officials, these constraints on policy can be seen as highly disadvantageous. But in a world where information is incomplete and dispersed, and where monopoly of political power is a continuing danger, the Tiebout model is a reminder of the potential value of the competitive process, even in the realm of jointly consumed goods.

A similar conceptual framework that has been used to discuss local public goods is the 'Theory of Clubs' in Buchanan (1965). This theory considers the class of services that are consumed jointly by club members but which are also subject to quality deterioration through crowding as the membership expands for any given capacity of the club's resources. New members lower the entry fee per member and spread the costs over a larger number of people, but they also, after a certain point, cause a deterioration in quality. Clearly there will be an optimal membership size for any given scale of output. Similarly, there will be an optimal level of output for any given size of club membership. The members of the club will compare the benefits of reduced crowding with the additional fees required to finance it. Efficiency requires that each club has optimal membership size for its collective output and optimal collective output for its membership size.

As a model of local public good provision, there are again some notable disadvantages. Clubs, as with Tiebout's local jurisdictions, will tend to attract people with similar preferences and incomes. Diversity of membership is unlikely to be a characteristic of a club equilibrium. Further, clubs are financed by fees that are the same for all members, just as Tiebout's local public goods are assumed to be financed by a lump sum tax on each person.

As a representation of the way state or local governments are in fact financed in federal or devolved systems, therefore, these models are not descriptively accurate. However, descriptive realism is not their purpose. Their focus is on the provision of local public goods as a category and the possible use of mobility as a demand-revealing mechanism. Given the rather pure assumptions that people are perfectly mobile and have no local dependency or affections, it is hardly surprising that the results do not reflect actual institutional arrangements. In particular, of course, models such as these make very clear the limited effectiveness of assigning an income redistribution objective to local jurisdictions when factors of production are very mobile.

The race to the bottom

One of the main objections to competition between jurisdictions is that, if conditions are not suitable, the competitive process will result in lower standards of public services than would be recommended by a social cost–benefit analysis.[11] This, of course, directly contradicts the Tiebout hypothesis and derives from differences in the analytical context. As has been pointed out, Tiebout jurisdictions finance local public goods by lump sum taxes and will tend to attract a homogeneous population. If, instead, we start the analysis by assuming that local jurisdictions (or states in a federation) finance their activities through proportional or progressive income or expenditure taxes, it is clear that high income people will pay a higher tax price per unit of the public good produced than low income people. These high income people could then be enticed away to other jurisdictions offering marginally better terms. Tax competition will mean that jurisdictions with a varied population by income will be unable

11 Sinn (2003) presents an extended analysis of 'systems competition' and the circumstances in which it can be expected to function destructively or in a beneficial way.

to charge differential tax prices, and the ability to finance public goods in a progressive way will be impaired.

In general, owners of mobile resources will find themselves subject to lower rates of taxation than those of immobile resources. Owners of financial capital, highly skilled labour and people with rights to profits from footloose corporations will be at an advantage compared with those who are relatively immobile or who own fixed property or land. From a pure efficiency point of view, this is not all bad news. The deadweight losses associated with taxes on labour and capital are substantial (as people adapt their work effort and investment strategies) compared with those on land or natural resources (Tideman and Plassmann 1998; Tideman et al. 2002). Indeed, there are strong ethical and efficiency arguments in favour of a tax structure that targets economic rent (i.e. pure surplus) over other forms of income. For communities of variable population size but with a given quantity of available 'land', it is even possible to show that the public collection of rent is capable of precisely financing an optimal supply of a single local public good.[12]

Nevertheless, the extensive list of shared competences in the EU testifies to the existence of a high level of suspicion of competition between the states. The 'approximation of legislation'[13] is a major objective of the treaties in areas such as health, safety and environmental protection. In general, the assumption is that to leave states solely responsible for these areas would lead to the erosion of standards and the undermining of the 'single market'. The regulation of interstate commerce is a fundamental federal responsibility, but just as the commerce clause has been used historically to extend central authority in the US, the EU has extended its remit in order to ensure the harmonisation of regulations and hence a level playing field. This can be seen clearly in the case of the

12 Stiglitz (1977) refers to this as the 'Henry George' theorem.

13 Title VII, Treaty on the Functioning of the European Union.

CAP, where the judgement from the earliest days of the EEC was that the power of the farming interests in each state was too great ever to permit the development of free trade in agricultural goods without centralised intervention to control subsidies.

To the extent that health, safety or environmental costs and benefits are truly local, however, harmonisation actually undermines interstate trade. Trade confers benefits when the relative marginal social costs of goods or services differ between states. Regulation that tries to smooth out real cost differences artificially is actually trade-destroying rather than trade-creating. The fear that drives the policy of harmonisation, however, is twofold. First, that, left to themselves, states might impose regulations that act as barriers to trade by protecting local producers. Second, that, faced with a highly competitive commercial environment, states might be unduly reluctant to introduce suitable regulations to correct for genuine, local market failures for fear of putting their domestic firms at a disadvantage. These two concerns push in opposite directions of course. In the first case, the state would be imposing regulations on importers that local producers could somehow circumvent. In the second case, a state would be considering and failing to introduce regulations within its jurisdiction because other states deemed them to be unnecessary. The similarity between the cases is that they both imply the danger of a mercantilist and protectionist policy bias in member states.

In a competitive jurisdictions system, however, it is necessary for regulation to be imposed on a destination basis rather than harmonised across member states. That is, each state should control the regulatory framework within its geographical area and should not discriminate against goods and services imported from other states. Under these circumstances, each state competes for mobile resources by providing local public goods and a suitable fiscal and regulatory environment within its area. The important requirement is that a court of law such as the ECJ

is capable of adjudicating in the case of disputes, and is able to pronounce on whether regulations or other measures are acting like non-tariff barriers or are simply reflecting a state's reasonable response to a perceived social harm. This will not always be easy, but similar judgements – for example, about whether commercial agreements are in restraint of trade – are regularly required in the area of competition policy.

Where a state's fiscal and regulatory interventions are tailored to its own circumstances in this way, a reluctance to introduce potentially socially beneficial measures because of foreign competition could only be explained by reference to the power of adversely affected special interests or other imperfections in local political processes. To a significant extent, therefore, the case for more centralisation is based on a lack of confidence in the ability of local political decision-making to reflect the interests of the local population as a whole. Assigning competence in these areas to a central authority is a way of constraining local politicians and interests. However, centralised decision-making processes, as has been noted, open the door to other even more powerful interests. This is because they operate across the entire Union and are less constrained by the force of interjurisdictional competition.

Conclusion

Economics provides plenty of powerful mechanisms for analysing federal systems – for example, the theory of public goods, public choice, interjurisdictional spillovers, the Theory of Clubs and interjurisdictional competition. It is evident, however, that the complexity of collective choice problems in federations means that simple rules about the assignment of competences are not easily derived.

The least controversial proposition is that local public goods should be supplied by local governments. Here, the economic

argument is simply that local decisions are more likely to reflect local preferences and supply conditions, and that local responsibility will also permit a degree of competition to take place (either through Tiebout-style migration or through the ability to compare performance between states). These efficiency considerations seem at first glance to be supported by the political principle of subsidiarity, which appears as one of the founding principles governing the limits of Union competences set out in the Consolidated Treaties of the European Union.[14] The mechanisms to support this principle, however, depend upon 'reasoned opinions' from National Parliaments to draft legislative acts[15] attracting sufficient support from across the Union. The tendency towards greater centralised intervention is unlikely to be much inhibited by this mechanism. Far from leaving undelegated powers with the states, the 'sharing' of competences requires continual (and costly) resistance to incursions on the part of the states. Furthermore, this resistance cannot appeal to clear principles of law but is forced to address the much vaguer question of whether 'the objectives' of a proposed action are or are not 'better achieved at Union level'.[16]

Spillovers between states and public goods that span a group of states as a whole favour more integrated decision-making. States clearly need to come together to agree on mutually advantageous measures. This might normally suggest the assignment of these matters to federal or Union decision-making mechanisms. Even here, however, we cannot conclude that it will be in the interests of every state to accept such an assignment. Centralisation does not ensure efficiency or even that every state will be better off (unless unanimity is the decision rule). The nature of the spillovers (whether uniform across states or skewed in the direction of other

14 Title 1, Article 5(3) 'Consolidated Treaties'.

15 Protocol (Number 2) 'Consolidated Treaties'.

16 Title 1, Article 5(3) 'Consolidated Treaties'.

particular states) and the details of the political processes involved would all be expected to determine the political outcome.

The most contentious areas concern policies aimed at redistributing income. With mobile factors of production, it is clear that local jurisdictions can be thwarted in their policies of redistribution. The literature on fiscal federalism, therefore, normally assigns welfare policy to the federal level. From the point of view of public choice theory, however, the case is much less clear cut. The tendency for government policies to be directed towards powerful special interests and for the relatively poor to vote for redistributive regulations and tax policies has been likened to the tragedy of the commons (see, for example, McGuire and Olson 1996). Voters and pressure groups in their self-regarding use of the political system do not take account of the effects on the economy as a whole. This can lead to an over-extended state sector (in the sense that everyone could, in principle, be made better off with a smaller one), as people try to use it to redistribute income in their favour. Rent seeking is, in other words, facilitated by democratic centralisation, while interjurisdictional competition will restrict it by giving the power of exit to politically vulnerable groups. Those with confidence in political processes and in favour of highly redistributive systems, therefore, will favour central assignment of competences related to welfare payments and related policies. Those who wish to restrict the redistributive zeal of governments prefer that the responsibility is retained at state rather than Union level.[17]

17 Sinn (2003: 78–81) proposes the 'home country principle' as an alternative to harmonisation or the existing 'inclusion principle', under which an immigrant is subject to the taxes and welfare benefits of the host country. This principle 'states that the country in which a person was born remains responsible for the welfare aid this person receives and the redistributive taxes he or she pays' (ibid.: 79–80). The legal, political and administrative problems of such a system cannot be reviewed here, but clearly it would in principle prevent migration from undermining welfare systems while placing constraints on the form that such systems might take. The state as a 'social insurance club' would not be subject to competition from other states because 'exit' would be restricted in this particular area.

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