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Assessing subsidiarity

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Abstract in English

This paper discusses the assessment of subsidiarity in the European Union from a broad fiscal federalism perspective. It incorporates recent insights from political economy analyses of fiscal federalism to arrive at a list of issues that need to be taken into account when considering whether concrete policies should be centralised in the European Union or not.

Key words: subsidiarity, fiscal federalism, political economy.

JEL codes: H11, H77, F15.

Abstract in Dutch

Dit paper analyseert subsidiariteit in de Europese Unie vanuit het perspectief van de economische theorie over federaties. Het incorporeert recente inzichten over de politieke economie van federaties en presenteert een aantal factoren die van belang zijn om af te wegen of beleid gecentraliseerd moet worden in de Europese Unie of niet.

Steekwoorden: subsidiariteit, federaties, politieke economie

Een uitgebreide Nederlandse samenvatting is beschikbaar via www.cpb.nl.

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Preface

Several developments underscore the need for a systematic assessment of the delineation of policies between the European Union and the member states: broadening of the scope of European policy over recent decades, enlargement of the Union and changing attitudes of citizens towards Europe. Therefore, the European Commission, CPB Netherlands Bureau for Economic Policy Analysis and the Dutch Ministry of Economic Affairs have organised a two-day conference on Subsidiarity and Economic Reform in Europe (November 8-9, 2006 in Brussels). The main topic of the conference is to discuss whether improvements in the division of competences between the Union and the member states exist that enhance the effectiveness of economic policy, in particular concerning the implementation of the Lisbon goals.

Serving as a background for the conference, this paper provides an overview of the economic arguments for decentralisation and centralisation of government policy. The paper is a co-production of Sjef Ederveen, who currently works at the Dutch Ministry of Economic Affairs and started this work while affiliated with CPB, George Gelauff, deputy director at CPB, and Jacques Pelkmans, Jan Tinbergen Chair and director of the Department of European Economic Studies at the College of Europe in Bruges and member of the Scientific Council for Government Policy in The Hague. The authors thank Albert van der Horst and Arjan Lejour for their comments.

Coen Teulings
Director

Summary

Assessing subsidiarity means reviewing the trade-off between decentralisation and centralisation for specific policy fields. In the context of the Europe, the principle of subsidiarity states that powers should only be shifted to the level of the European Union, when the member states themselves can not achieve the same results. To assess that principle, it is necessary to examine which arguments underscore decentralisation and which centralisation. This paper presents these arguments, based on a survey of the literature on fiscal federalism, including recent papers that take a political economy perspective.

The basic economic theory of fiscal federalism explores the trade-off between preference matching and internalisation of cross-border external effects or economies of scale. The principal motive for decentralisation is to match the variety of preferences that exist in different jurisdictions or member states in case of the EU. In contrast, centralisation may be warranted when a national policy of a member state has consequences for another member state that are not taken into account in its decision making process (cross-border externalities). In addition, the presence of fixed costs may make decentralised policies suboptimal. In that case centralisation benefits from economies of scale. This trade-off leads to a functional subsidiarity test that emphasises the justification of centralisation by cross-border externalities or economies of scale.

The functional subsidiarity test is based on three main assumptions about government behaviour: benevolent governments that face no costs of policy design, provision of uniform policies at the central level, and a mode of decision making in which each level of government act as a central planner. Relaxing these assumptions adds political economy arguments to the analysis. When national governments pursue their own interests instead of the public interest, decentralisation may enhance accountability. It provides citizens with stronger opportunities to monitor and control governments. In addition, policy competition between decentralised governments may create incentives for governments to seek the public interest and to provide services efficiently. At the level of the EU government failure may arise, if Europe pursues overly centralistic policies and is able to implement these. Effective monitoring and control by the member states may act as a counterbalance.

Imperfect governments may fall victim to lobby groups. The impact of lobbying on the trade-off between centralisation and decentralisation is indeterminate. It depends on the specific conditions in a given policy area whether a central or a local government faces a higher risk of being captured. In particular, if the objectives of domestic and foreign lobby groups are aligned, centralisation means that the foreign lobby obtains an additional channel to influence the domestic government.

At times governments face considerable challenges to devise adequate measures in complex policy fields. Even a government that honestly pursues the common good may not be knowledgeable or creative enough to devise the most suitable policies. Decentralisation

facilitates experimentation and creates possibilities for mutual learning. On a centralised level policy learning can be strengthened by information exchange and building commitment to engage in economic reform. In this respect a trade-off does not exist: decentralisation and centralisation are complementary.

Abandoning the assumption of a central planner makes the analysis of decision making at the centralised level more realistic. European governance can be considered as a type of federalism in which regional delegates form a legislature that makes decisions. This type of federalism brings about several inefficiencies associated with centralisation. An attitude of deference among the representatives in the legislature may result in approval of inefficient policies and projects, such as transfers that benefit specific regions. Common pool problems, in which member states have an incentive to draw as much as possible on the common budget for projects that locally provide benefits, may also lead to over-supply of public goods at the central level. These inefficiencies may raise the weight of decentralisation in the trade-off between decentralisation and centralisation.

The division of competences between Europe and the member states is not fixed. In the course of time trends, such as globalisation, may affect the trade-off between decentralisation and centralisation. For instance, larger foreign direct investment flows may increase cross-border externalities when countries try to attract subsidiaries of multinational companies. Trends may imply that the subsidiarity assessment of tomorrow differs from that of today.

1 Introduction

Many people claim that Europe is in a political crisis. With the enlargement of the European Union with ten new member states in May 2004, there is a strong need for reconsidering the political decision making processes in the European Union. The political leaders tried to cope with this need by designing a Constitution for the European Union. However, the voters in France and the Netherlands opposed ratification of this Constitution in mid-2005. The reasons behind this rejection were diverse. Some people voted against the Constitution because they felt that it was going too far, others voted against it because they felt it was not going far enough (see Dekker and Ederveen, 2005, for further analysis of this issue). This heterogeneity of attitudes towards further Europeanisation has been well recognized by the European Commission. It was therefore decided to postpone referendums in a number of other countries and opt for a period of reflection, in which the need and ambition of a new treaty for the European Union could be reconsidered.

There is indeed a search for the optimal design of the European Union. After the successful conclusion of the Internal Market program in 1992, the scope of the European Union has gradually been widened to include areas of public policy that previously remained within the more or less exclusive powers of the member states. Such areas include monetary and budgetary policy (through the Stability and Growth Pact), energy and telecom, environmental policy, social policy, innovation policy and immigration policy. Although the extent of European involvement widely differs in each domain, it seems nevertheless clear that, nowadays, Europe matters far beyond the common market for goods, and also includes increasingly wider elements of the public domain.

The causes for this widening of scope are various. The introduction of EMU was meant to strengthen the European economy per se by handing over sovereignty in monetary policy to Frankfurt. Cross-border environmental problems in Europe legitimised a common European approach. The liberalisation trend in member states implied that (semi) public services (energy, health care) had to fit within existing European schemes of the internal market, competition policy and state aid. The Lisbon process brought economic reforms in the member states within the realm of European coordination. For instance, with innovation being a target in the Lisbon agenda, European cooperation in innovation policy was strengthened. Some other areas apparently were included in the European agenda to show European citizens that European integration was not simply an 'economic' affair, but also related to social concerns.

Whatever the causes of a more prominent role for Europe, it is not at all clear beforehand whether the current level of centralised decision making is necessary and desirable in the European Union and whether further centralisation will be justified. To quote Pisani-Ferry and Sapir (2006): 'Also the EU rationale of any item on the Lisbon 2 agenda¹ should be spelled out explicitly.' To make such a claim, requires explicitly weighing the pros and cons of

¹ Lisbon 2 is the revitalised Lisbon strategy after the midterm review in 2005-2006.

centralisation. This is in accordance with the principle of subsidiarity, which states that powers should only be shifted to the level of the European Community, when the member states themselves can not achieve the same results.

To provide inputs for an assessment of subsidiarity in specific policy fields, this paper reviews the main motives for decentralisation and centralisation. Several motives underscore decentralisation, such as the ability to align policy closer to the preferences of regional constituents. In contrast, centralisation may be warranted in a policy field characterised by increasing returns to scale or it may be useful if thereby it could create commitment for economic reform. However centralisation may also fail to be useful, for example when local jurisdictions attempt to extract funds from the budget of a higher level of government.

Subsidiarity in the European Union

In the European context the principle of subsidiarity was only introduced quite recently. Although it is now generally acknowledged as the guiding principle for dividing powers in the European Union, it was hardly ever mentioned in the official European texts until the late 1980s. Fears of centralised power then led to the idea to place the burden of argument with the advocates for further European integration. This idea was especially supported by Britain and Germany. Britain feared European federalism, and the German Länder sought to maintain their exclusive powers enjoyed in the German Federal Republic. (Føllesdal, 1998) The first time that the principle of subsidiarity is explicitly mentioned is in the European Single Act of 1986 (article 130r, ad 4), dealing with environmental policy.

Finally, in 1992, the principle of subsidiarity was officially introduced in the 1992 Maastricht Treaty (article 3b), and moved to article 5 in the 1997 Treaty of Amsterdam. The formulation in article 5 holds that:

1. "The Community shall act within the limits of the powers conferred upon it by this Treaty and of the objectives assigned to it therein."
2. "In areas which do not fall within its exclusive competence, the Community shall take action, in accordance with the principle of subsidiarity, only if and in so far as the objectives of the proposed action cannot be sufficiently achieved by the Member States and can, therefore, by reason of the scale or effects of the proposed action, be better achieved by the Community."
3. "Any action by the Community shall not go beyond what is necessary to achieve the objectives of this Treaty."

This formulation first identifies the applicability of the principle. It is limited to those areas where the Community and the member states have shared powers. Then it goes on to identify reasons (scale or effects) that may call for centralisation. It concludes with the proportionality claim that any action should be as simple as possible. Note that this paper takes a general view on subsidiarity, which in principle can be applied to any policy domain, and thus abstracts from the first condition in article 5.

The motives for centralisation and decentralisation follow from the literature on fiscal federalism, including recent analyses that take a political economy perspective. Section 2 reviews the basic arguments starting from the premise of a benevolent government. Section 3 adds motives related to government failure and policy learning. Section 4 focuses on the political process between a number of countries that delegate representatives to a central legislature, which makes decisions at the centralised level. It identifies several failures of centralisation that originate from negotiations and conflicts of interests in the legislature.

Section 5 touches upon dynamic aspects of subsidiarity. Centralisation that was optimal two decades ago might not be optimal anymore. Section 6 concludes with an overview of the major motives relevant to an assessment of subsidiarity.

Subsidiarity and centralisation

In the debate about subsidiarity, people often confuse the concept of subsidiarity with delegating power to the lowest possible level. With respect to accession to EMU, Hughes-Hallett and Lewis (2004) for instance claim that “the principle of subsidiarity should apply to Euro membership, placing decisions over entry in the hands of individual member states.” And also in their otherwise excellent paper on subsidiarity, CESifo (2003) states: “With heterogeneity in preferences, the principle of subsidiarity should be applied, that is each country should be allowed to choose its preferred combination of wages and social standards.” However, it would be a mistake to think of subsidiarity and lower level decision making as synonyms. The subsidiarity principle in itself is neutral about the optimal degree of centralisation. Rather, it involves a careful assessment of the optimal level at which decisions should be taken. Instead of a preference for lower levels of government, this does imply a proper cost-benefit analysis of (de)centralisation.

2 Fiscal Federalism: the basics

The economic arguments that guide the debate on subsidiarity are rooted in the theory of fiscal federalism². The economic theory of fiscal federalism explores when centralisation of public economic functions is welfare improving. This theory finds its foundation in the paper of Musgrave (1959) in which he discusses the optimal level of centralisation of several public economic functions. The basic or first generation (according to Oates, 2005) theory of fiscal federalism explores the trade-off between preference matching and internalisation of interjurisdictional external effects or economies of scale. To arrive at this trade-off, section 2.1 presents the assumptions on government behaviour that underlie the standard model, section 2.2 focuses on preference matching as a motive for decentralisation and section 2.3 turns to the motives for centralisation. Section 2.4 then discusses a functional subsidiarity test to determine the optimal assignment of competences within the European Union.

2.1 Government behaviour

The point of departure is a region, which consists of a number of jurisdictions. A clear example is a federation, such as Germany, or the EU and the member states, which is the topic of this paper. The government provides a public good. Then the principal question is whether the centralised government (EU) or the local governments (the member states) should supply the public goods. The basic theory as elaborated in Oates (1972) is based on three main assumptions on the behaviour of governments:

1. Benevolent and perfect government

Each level of government maximises the welfare of its constituency. This implies that different layers of government always act benevolently. They do not pursue their own interest or fall victim to lobby groups. Moreover, policy design involves no transaction costs or costs of policy learning.

2. Policy uniformity

The central government provides a uniform level of a public good in all jurisdictions. This assumption is not straightforward.³ A perfectly informed central planner would be able to provide public goods in each jurisdiction according to local preferences or local needs. Two motives underlie policy uniformity (Oates, 2005, p353). Firstly, information gathering comes at a cost and central governments face higher costs to learn the preferences of local constituencies

² Fiscal policy was the main topic of research in the original literature. Although economic federalism would be a more accurate description nowadays, 'fiscal federalism' has become the accepted term and therefore we will use this here. In the EU-context the theory is also referred to as the theory of multi-tier or multi-layer government.

³ With the great heterogeneity in the European Union, policy uniformity is often far from optimal (see e.g. CESifo, 2003, for an illustrative example of these problems).

compared to local governments. Secondly, central government faces political constraints to treat one jurisdiction more generous than another.

3. **Centralised decision making**

Each level of government acts as a central planner. This implies that the highest level of government consists of a president or small executive council (the central planner) elected by all citizens of the union. Inman and Rubinfeld (1997, 2002) refer to this form of federalism as economic or centralised federalism.

2.2 **Decentralisation: preference matching**

In the standard model the principal motive for decentralisation follows from the diversity of preferences for public goods in jurisdictions. Both preferences for public goods and circumstances that affect the demand for public goods differ widely in jurisdictions. Concerning preferences, countries may have different views on the role of the government and on the need for centralisation or decentralisation (compare Box). Alesina and Perotti (2004) emphasize the distinction in Europe between the dirigiste attitude, characterised by heavy government intervention in markets, and the more laissez-faire Anglo-American attitude. Cultural characteristics may underlie this diversity of preferences (compare Dekker *et al.*, 2006). In addition, European countries differ in physical conditions, sectoral structure, infrastructure, etc. This may affect the emphasis they put on different public goods. For instance, countries with a large agricultural sector may attach a higher weight to agricultural policies than other countries. As an other example, a country with a large transport sector benefits relatively more from investment in infrastructure. Hence, diversity in endowments may result in diversity in weights attached to specific goals of economic policy.

When preferences differ over jurisdictions, *preference matching* is the main motive for decentralisation. Combining the assumptions on policy making in the previous section with the likelihood of preference heterogeneity, Oates (1972, p.54) derived formally the so-called decentralisation theorem. The intuition behind the decentralisation theorem is that except in the extreme case that preferences across jurisdictions are the same everywhere, decentralisation will bring welfare gains as outputs can be diversified in accordance with local preferences and conditions. Preference matching as a motive for decentralisation has to be weighted against the motives for centralisation, which are the subject of the next section.

Preference heterogeneity

Between European countries there may be considerable differences in preferences. The table below, adapted from Dekker and Ederveen (2005), shows how strong opinions differ over the desirability of a common European policy between the current 25 member states of the European Union. In general the Scandinavian countries least favour further integration, whereas the new member states generally show the highest preference for common European policies in different areas.

Preferences for European policy in the 25 member states of the European Union, 2004, (unweighted) averages of the national percentages of the population aged 15 and over and deviations by the countries from this average in percentage points^a

	EU-25	Min	Country	Max	Country	NL
The war against international terrorism	90	80	UK	95	LT	94
Scientific and technological research	76	52	DE	93	CY	76
The war against drugs	75	56	LU	87	PL	68
Foreign policy towards countries outside the EU	73	58	SE	83	BE	78
Humanitarian aid	72	43	SE	83	LT	73
Aid to regions with economic problems	68	41	FR	83	PL	64
Environmental protection	67	46	FI	82	PL	73
Tackling poverty and social exclusion	61	47	DK	76	LT, CY	47
Defence	57	13	FI	78	LV	64
Immigration policy	57	29	FI	82	LT	59
Agriculture and fisheries policy	53	20	FI	71	CY	65
Tackling unemployment	52	30	FI	73	LT	40
Tackling the problem of ageing	51	22	SE	80	CY	30
Admission of refugees	52	22	FI	74	ES	50
Education	39	21	FI	58	LT	27
Health and social security	37	7	FI	70	CY	22
Justice	37	14	DK	70	LT	33
Elementary guidelines for radio, TV and press	34	15	DK	56	CY	26
Cultural policy	32	15	SE	51	ES	22
Police	30	13	SE	50	ES	22
Preference for European policy: average	56	38	FI	71	LT	52

^a For each of the following areas, can you tell me whether you consider decisions should be taken by the [national] government or within the European Union? A total of 27 policy areas and topics were submitted to respondents, of which 20 are shown here. 'Don't know' answers have been left out. Example of how to read table: on average 90% of the population in the member states considers that the war against international terrorism should be tackled in the European context; in the United Kingdom the figure is 80% and in the Netherlands 94%.

Source: Eurobarometer 62.0 (October-November 2004); weighted results.

2.3 Centralisation: cross-border externalities and scale

Cross-border externalities and economies of scale are the two main motives that may call for centralisation (Oates, 2005). In the EU *cross-border externalities* arise when a national policy of a member state has consequences for another member state that are not taken into account in its decision making process. These externalities can both be positive or negative. Investments in Research and Development (R&D) provide an example of possible positive externalities. When Germany doubles its investments in R&D, other countries, especially the neighbours, could benefit from the spread of knowledge (Ederveen *et al.*, 2005). However, these potential benefits are not taken into account by Germany when it decides about its level of investment. Therefore, from an efficiency point of view countries will generally invest too little in policies that generate positive spillovers. In the same vein it could be argued that policies that create negative spillovers will be overrepresented. An example is cross-border pollution. Higher levels of government can internalise both negative and positive externalities. This could justify the centralisation of a certain policy.

Economies of scale provide another rationale for centralisation. When policies are costly, especially due to fixed costs, decentralised policy making is bound to be suboptimal. In such a case, centralised policies could improve welfare. An example is CERN, the particle physics laboratory near Geneva that is supported by many European countries.

2.4 The functional subsidiarity test

Combining the motives for centralisation and decentralisation results in the following trade-off:

<i>Decentralisation</i>		<i>Centralisation</i>
preference matching	<=>	cross-border externalities economies of scale

Given a certain degree of preference heterogeneity, centralisation is only desirable when externalities or economies of scale are sufficiently large.⁴ Based on this principal trade-off between preference matching versus scale and cross-border externalities, Pelkmans (2006) derives a functional subsidiarity test. The general test consists of the following three steps:⁵ Is centralisation justified by the existence of economies of scale and/or externalities?

⁴ Formally larger externalities imply more centralisation, but more preference heterogeneity does not necessarily imply less centralisation. This is because more heterogeneity may not only raise the social costs under centralisation, but may also raise the costs of inefficient provision of public goods when externalities are not taken into account under decentralisation (Besley and Coate, 2003, p2616).

⁵ Pelkmans (2006) includes another step which determines whether the policy falls in the area of shared competences. To make the test more general, i.e. not bound by the treaty's text, we exclude this step here.

- Is credible voluntary cooperation possible?
- If the answer on the first question is yes, and on the second no, then the (proper) assignment is at the EU level. The third question then is that of proportionality: To what degree should the implementation and enforcement be centralised as well and can policies be designed in a cost-minimising manner ?

When economies of scale or cross-border externalities exist, the first step, the need-to-act-in-common test is passed. Still there is no need for centralisation, if all Member States would voluntarily cooperate on a given policy issue and this cooperation is credible. Credibility is an important criterion to decide upon centralisation or decentralisation. When credibility is low, cooperation will be unsustainable and a central policy is needed. Credibility will be particularly low when information is highly imperfect or asymmetrically distributed, especially in complex policy areas, because this renders it impossible to monitor compliance. Credibility is also low when the incentives to cheat are strong and the ability or willingness to impose collective sanctions is perceived as minimal. If voluntary cooperation cannot come about, or it would not be credible, there is a case for centralisation.

When there is a case for centralisation, it has to be decided how it should be implemented, monitored and enforced. This is the third and last step of the test. Here the question of proportionality is relevant: no more than what is necessary to achieve the goals of the actions should be done at the central level. Where possible and efficient, member states should play the primary role in policy implementation. Therefore, in principle coordination and recommendations are preferred over legislation (compare the box in section 4 on EU economic governance). If binding measures are needed anyhow, directives should be considered before EC regulations. In this way maximal discretion is left to the member states, while internalising the cross-border externalities.

The test described above is a purely functional test of subsidiarity. Such a test is indispensable for a proper assessment of the assignment decision. However, it is certainly not the full story. The trade-off between preference matching and cross-border externalities or economies of scale is derived under a set of rather strict assumptions regarding the political process. If one wishes to understand the subsidiarity debate in the EU, the political perspectives should also be taken into account. Relaxing the assumptions of section 2.1 yields a more realistic and at the same time more complex view of the choice between decentralisation and centralisation. That is the subject matter of the next sections.

3 Government imperfections

Dropping assumption 1 of benevolent and perfect governments, imperfections in policy formulation come to the fore. Pelkmans (2006) distinguishes two well-known cases of government failure: Leviathan and lobby. A Leviathan government pursues its own interests in contrast to the public interest. Self-interested governments may exist on a local level and on a central level. Therefore, sections 3.1 and 3.2 review the consequences of Leviathan governments in the member states and the EU, respectively. Successful lobbying may result in governments being captured by organised interest groups. This is the subject of section 3.3. As a third case, policy design may be characterised by imperfections. Also when governments do not deliberately pursue their own interest, they still may struggle with policy formulation. Section 3.4 turns to the issue of (de-)centralisation when policy design is a learning process, which requires appropriate and sufficient incentives to take place effectively. Section 3.5 addresses complementarities between policy fields, which may create dependencies between centralisation decisions over policy fields. Finally section 3.6 touches upon second best arguments that may ask for centralisation to correct failures of decentralisation, or vice versa.

3.1 Leviathan in the member states

Decentralisation may contain Leviathan either through stronger opportunities for citizens to control government (voice) or through the exit option: voting with their feet. In the latter case citizens leave jurisdictions with Leviathan governments for jurisdictions with more reliable governments or policies closer to their preferences. As Tiebout (1956) showed, competition among local regions is welfare improving for society as a whole, as the resulting heterogeneity allows citizens to move to the region that reflects their preferences with respect to taxes and public goods best. However, mobility of labour between European countries is not that large, so voice would be the most important mechanism (Pelkmans, 2006).

In addition, decentralisation enhances policy competition (Tabellini and Wyplosz, 2004). One of its benefits may be to contain Leviathan governments. For instance, if governments have distorted incentives to increase spending and taxation, tax competition may raise welfare. Inter-regional competition also forces governments to provide services efficiently. Hence decentralised provision of public goods and the resulting competition may alleviate government failure.

These arguments pro decentralisation add accountability to the decentralisation side of the trade-off. Because they are more responsive to ‘voice’ and because they are constrained by policy competition, decentralised governments are more accountable to their constituents. With Leviathan governments ‘decentralisation may be preferable even in cases of perfect homogeneity of preferences across local jurisdictions’ (Oates, 2005, p358).

Adding this motive for decentralisation, a trade-off arises between on the one hand preference matching and accountability as arguments for decentralisation and on the other hand externalities and increasing returns as arguments for centralisation:

<i>Decentralisation</i>		<i>Centralisation</i>
preference matching	<=>	cross-border externalities
accountability		economies of scale

Applying the trade-off to concrete policies, the drawbacks of policy competition should be taken into account. An expanding literature argues that policy competition has its limits as a way to contain Leviathan and to improve the efficiency of policy making. Sinn (2003) states that the so-called *selection principle* fetters policy competition. National governments intervene in the economy to counter market failures. Yet, according to the selection principle, competition between governments through the backdoor may bring back the market failures national policies were meant to resolve. For instance, competitive states may have an incentive to promote national champions, which may be at odds with national competition laws. Moreover, policy competition lacks price signals that guide competition on the market. Hence, if market failures manifest themselves on an international scale, policy competition between countries may be a blunt instrument to enhance the quality of policies and institutions.

Finally, to some extent centralisation may enhance policy competition. For instance, EU coordination may enhance regulatory competition, when countries strongly monitor each other on the way they comply with the internal market directives (Pelkmans, 2006).

3.2 Leviathan in Brussels

In the context of the EU, government failure may arise, if the Commission pursues overly centralistic policies and is able to implement these.⁶ For instance, Pollack (2003, p16) in an empirical study on delegation in Europe concludes: ‘Despite their internal complexity and diversity, EU supranational agents generally behave like unitary actors with preference for further integration’. To display that behaviour, the Commission should have both incentives for centralisation and sufficient discretion to achieve centralisation.

Incentives may come from a relatively pro-centralisation stance of people working at the Commission. Through self selection people applying for a job at the Commission may be above average pro centralisation. Socialisation during their working life with European ideals and interests may add to this attitude. Of course bureaucratic policies may also play a role, such as expanding the power of directorates. Finally, national governments may delegate people with a

⁶ This argument can also be exaggerated. National governments can use the EU as a crowbar or scapegoat to convince their constituency that unpleasant policies are unavoidable. Recent experiences in some member states have shown that such a strategy may ricochet in undermining the public support for European coordination.

relatively pro centralisation mind-set to counter time inconsistency (Majone, 2001, 112). The reason is that national governments know that they may have short run incentives to renege on their commitment to European integration. Delegation to the EU level solves this only if the preferences of the delegates do not simply mirror those of the delegating authority. Otherwise delegated EU officials would give in to the same short-run incentives as national governments.

Discretion of the Commission to promote centralist policies depends on its agenda setting capabilities and on monitoring and control activities by member state governments. Agenda setting may be formal and informal (Pollack, 2003, p47). Formal agenda setting implies the right to set the procedural agenda and initiate legislative proposals. The formal agenda setting power of the Commission is greatest when it has the sole right of initiative and when its proposal can more easily be adopted than amended. Informal agenda setting concerns influencing the member states and having them make proposals that comply with the interest of the Commission.

Control and EU institutions

Analogous functional separation within the Commission and the relevant Council formations may weaken control by member states. Both Commission Directorates-General and Council formations are organised along comparable policy areas. For instance, in the Ecofin Council DG Ecfm and Ministries of Finance meet; in the Employment, Social Policy, Health and Consumer Affairs Council the same applies to DG Employment and Ministries of Social Affairs and Employment. Each Council formation operates in relative isolation and discuss issues relevant to their policy area from their perspective. Exceptions are the Competitiveness Council and the European Council of heads of state and government. In particular the later Council would be able to provide an overall view and exercise countervailing power, because almost all proposals of Council formations have to be approved by the European Council. However, the European Council discusses only controversial guidelines at length, it endorses many proposals from Council formations without much review.

Free rider problems and diverging interests among member states may hamper monitoring and control by member states. The free-rider problem is well-known in principal agent models with multiple principals (the member states) and costly monitoring of an agent (the Commission). Each principal faces an incentive to avoid monitoring and control costs and to free ride on activities by other principals. Diversity among principals enables the agent to exploit different or even conflicting preferences. In some cases it may use some kind of ‘divide and rule’ strategy. That may enable the Commission to reach its goals through selectively addressing member states that may oppose its proposals (Scharpf, 1999, p69).⁷ The Commission may first address a single member state, for instance by acting against protectionism or state support. If it succeeds (in court) that may reduce opposition by other member states. Moreover, the country that lost its case is likely to become an ally of the Commission. If it has been convinced or forced to act unilaterally and expects to be at a disadvantage to other countries that have not

⁷ Successfully pursuing such a strategy requires a strong legal base.

acted yet, it will side with the Commission in proposing a general directive that applies to all member states.

The efficacy of control also depends on the institutional setting of an agent (Pollack, 2003, p44). An agent's room for manoeuvre is greatest when the decision rule for the application of sanctions is most demanding (unanimity among principals). Also relevant is the default condition in the event of no agreement among principals. If it is status quo, i.e. continuation of already existing institutions and policies, sanctioning becomes more difficult.

This section has shown that EU government failure may arise if monitoring and control by lower level authorities is unsuccessful. For specific policy fields policies may become overly centralistic, depending on agenda setting capabilities of the Commission, on the diversity of views among member states and on the default condition when member states disagree.

3.3 Lobby

Lobbying is an other case of government failure. Governments always risk to become captured by interest groups. That risk exists both at the national level and at the EU level. The theoretical literature does not unequivocally support the 'traditional intuition that local government is more susceptible to capture by lobbies' (Lockwood, 2005). Among others, it depends on whether citizens are better informed at the central level or at the local level and on the strength of the lobby at each level. Moreover, it may be more cost effective to lobby central policy makers, because that involves less players.

Furthermore, lobbying may influence the decision to centralise. In some cases capture may prevent beneficial centralisation. Pelkmans (2006) gives the example of national interest groups that through national governments obstruct internal market liberalisation. In contrast, with reference to the common agricultural policy he also illustrates that national interests may prompt centralisation.

Tabellini and Wyplosz (2004) argue that the impact of decentralisation or centralisation on the efficacy of lobby's depends on whether the objectives of domestic and foreign interest groups are aligned or not. If interests coincide, centralisation means that the foreign lobby obtains an additional channel to influence the domestic government. For instance, through centralisation domestic producers lobbying for low consumer rights or limited environmental protection may find support from foreign producer interest groups. Yet foreign interests may also oppose domestic interests, in which case centralisation weakens the efficacy of lobby activities. Foreign producers would lobby against domestic producers that attempt to create barriers to entry on domestic markets.

All in all, the impact of lobbying on the trade-off between centralisation and decentralisation is indeterminate. It depends on the specific conditions in a given policy area whether a central or a local government faces a higher risk of being captured.

3.4 Policy learning

Imperfections in policy design may result from difficulties with policy learning. At times governments face considerable challenges to devise adequate measures in complex policy fields, like for instance intricate transitions in network industries. Even a government that honestly pursues the common good, may not be knowledgeable or creative enough to devise the most suitable policies or may be slow in picking up signals from society that reform measures are needed, because institutions have become outdated.

Decentralisation may stimulate policy learning. Decentralisation creates diversity in policy, which yields experiences with policy in one jurisdiction that may benefit another. In that way decentralisation facilitates experimentation and creates possibilities for mutual learning. Of course learning only takes place when jurisdictions are aware of experiences in other jurisdictions and have an incentive to heed these experiences.

One of the intentions of the open method of coordination (OMC) is to enhance this kind of policy learning. Member states benefit from experiences in other member states through soft coordination at the EU level (see the box in section 4 for the position of the OMC in EU governance). Under the Lisbon strategy the OMC is applied to a broad range of policy fields, ranging from labour markets and welfare states to education and innovation. The method consists of identifying common objectives for national policy, devising associated performance indicators, drafting policy proposals in National Reform Programmes and mutual assessment of these programmes in EU committees.

In principle the OMC seems geared to policy learning, even so whether learning really takes place depends on the effectiveness of the OMC. Here the jury is still out. An important consequence of this form of soft coordination is that incentives to change policies are soft as well (Sapir *et al.*, 2004). In the recent reform of the Lisbon strategy the focus is on ‘delivering’, with the discussion of National Reform Programmes in member state’s parliaments as one of the measures to intensify incentives for action. Empirical evidence on the impact of the OMC on policy learning is still limited and yields mixed results (Ederveen *et al.*, 2005). The most successful empirical results pertain to evidence about convergence of ideas (Radaelli, 2003).

In summary, decentralisation may enhance policy learning through experimentation, which on a higher level can be strengthened by information exchange and building commitment. In that respect, a trade-off does not exist: decentralisation and centralisation are complementary. However, the inherent soft coordination due to primarily national responsibility for policy decisions, generates weak incentives for policy learning.

3.5 Complementarities

Complementarities across policies domains may affect the assessment of subsidiarity. Complementarities imply that a move towards centralisation or decentralisation in one

dimension increases the benefit of moving in the same direction in other dimensions. For instance, EMU initiated the discussion about the Stability and Growth Pact, because centralising monetary policy affected the costs and benefits of fiscal centralisation (Persson *et al.*, 1996). EMU also provides a rationale for coordinating reforms among euro area countries (Pisani-Ferry, 2005). The reason is that in a monetary union, a country that pursues reforms exerts an effect on its EMU partners, because the European Central Bank will adjust the interest rate in response. As an other example, liberalisation brings policy areas within the confines of the internal market that previously were delivered by national public providers.

Because of complementarities the decision to centralise policy in a specific field may have farther reaching consequences than initially recognized. Once a first step has been taken other policy domains may follow suit. Therefore, a full cost benefit analysis of centralisation would have to include both the initial and the complementary policy fields. Another possibility is that complementarities create deadlocks. Pisani-Ferry and Sapir (2006) give the example of complementarities between product market reforms and labour market reforms: ‘a combination of product market regulations that aim at favouring entry and of labour market regulations that aim at preserving existing jobs is a recipe for ineffectiveness. Hence, when assessing subsidiarity, possible complementary policy domains should be taken into consideration as well.

3.6 Second best

Government imperfections introduce second-best arguments in the deliberations. Those arguments can tip the balance between centralisation and decentralisation: (de-)centralisation can be welfare improving although it was not in the absence of distortions.

Persson *et al.* (1996) emphasize this point and give the example of education. Because economies of scale and cross-border externalities of education are not very high (see Thissen and Ederveen, 2006), educational policy should be decentralised according to the functional subsidiarity test in section 2.4. However, Persson *et al.* (1996) state: ‘ Many observers take the view that national university systems are poorly organised and inefficient (particularly in comparison with the US), because sectoral and regional interests have led to inefficient regulation and to a poor allocation of government budgets’. In that case EU policies that promote mobility of students and researchers, may increase competition between European universities and may enhance efficiency and quality of education and research.

Hence, centralisation may be warranted to reduce government failures at the national level. The opposite case is possible as well: decentralisation may be advisable to counter government failure at the EU level (see section 3.2).

4 Decision making in legislature

The analysis above assumes that decisions in the union are being taken by a central planner, such as a president or executive council, elected by all people in the union. Abstracting from that assumption introduces the possibility of conflicts of interest at the centralised level that negatively affect decision making. These drawbacks reduce the benefits of centralisation and may shift the trade-off between centralisation and decentralisation towards decentralisation.

Abandoning the assumption of a central planner, it matters how the decision making process is organised at the centralised level. This section takes the perspective that regional delegates form a legislature, which makes decisions.⁸ As such it relaxes assumption 3 from section 2.1. At the same time also assumption 2 of policy uniformity is dropped, to create the possibility that representatives engage in centralised policies that specifically benefit their regions of origin. Moreover, policy heterogeneity can be observed in practice. Frequently in federal systems a central government differentiates the provision of public goods over jurisdictions (Besley and Coate, 2003).⁹

In their paper on subsidiarity Inman and Rubinfeld (2002) distinguish two alternatives for *economic or centralised federalism*, the central planner from section 2.1. In *cooperative or decentralised federalism* representatives of the member states' governments unanimously decide on central government (union) policies. In *democratic or majority-rule federalism* representatives of the member states decide on central policies by (simple) majority rule.

Inman and Rubinfeld (2002) argue that European governance changed from decentralised federalism via centralised federalisms towards democratic or majority-rule federalism nowadays. Initially under the Treaty of Rome (1957) decentralised federalism characterised the Union: the powerful Council of Ministers voted with unanimity on major issues. The Single European Act of 1986 shifted the institutional structure towards centralised federalism. Replacing the rule of unanimity by a consultation procedure considerably increased agenda setting powers of the executive, the Commission. Since the 1991 Maastricht Treaty and the 1997 Treaty of Amsterdam, the co-decision procedure put the European Parliament on equal footing with the Council of Ministers. By consequence, today the Union consists of an institutionally weak executive without veto powers together with two equally powerful bodies (Council and Parliament), 'each capable of blocking the preferred outcomes of the other' (Inman and Rubinfeld, 2002, p9). This most closely fits in with democratic federalism.

⁸ This extends the original theory by focussing on political processes, the behaviour of political agents and distortions arising from asymmetric information. Oates (2005) refers to these extensions as being part of the second generation theory of fiscal federalism.

⁹ The two assumptions have to be combined, because centralisation would always be preferable when discarding policy uniformity while keeping central planning (see section 2.1).

EU economic governance

Sapir *et al.* (2004) distinguish four types of governance arrangements in the European Union:

- Full *delegation* of policies to the Union, such as trade policy (internal market, WTO) or competition policy.
- Binding *commitment* among member states. In this case member states have agreed on EU surveillance and EU sanctions for policies that remain their ultimate responsibility. An example is state aid oversight by the Commission.
- *Coordination* of policies that are decided and implemented by the member states. Coordination covers:
 - explicit guidelines subject to multilateral surveillance (Broad Economic Policy Guidelines)
 - collective rules (Single Market regulations)
 - high-level dialogue (Eurogroup)
 - mutual information and assessment (Open Method of Coordination)
- *Autonomy* of member states to decide on and implement policies, for instance in the field of direct taxation.

Over time a shift has taken place from delegation (internal market, EMU) to commitment and coordination, which features prominently in the Lisbon strategy. Comparing the internal market and the Lisbon strategy Sapir *et al.* (2004) conclude: 'Narrow intermediate objectives, precisely defines means and effective instruments have been replaced by broader objectives, softer means and weaker instruments'.

The following subsections treat two main consequences of decision making in a legislature.

Section 4.1 touches upon an attitude of deference in the legislature towards each others' proposals. Section 4.2 covers possible conflicts of interest in the legislature. Section 4.3 turns to the effects of deference and conflicts of interest on the trade-off between centralisation and decentralisation.

4.1 Deference in negotiations

Decision making in a legislature requires negotiations between national representatives about the kind of policies to be addressed at the central level. In single issue bargaining the decision to centralise a policy depends on the bargaining power of countries and on the differences in weights that individual countries attach to that policy and to centralisation. In practice negotiations take place in a setting of multiple goals and repeated games. In the European Council national governments continuously negotiate about a broad range of policies. In those cases 'allowing' centralisation on one specific policy may act as a kind of side payment to obtain support from countries with low weights on centralisation for other policies. In particular, if one country attaches a large weight to a specific policy, the other countries may allow centralisation on that specific policy. On the one hand this may facilitate finding a solution when a minority strongly opposes a certain policy proposal. Yet, on the other hand this process may 'get out of hand'. If all countries try to lever their national policies by lifting them to a European level, the process of deference may result in centralisation on policies that would not pass a subsidiarity test.

The risk of deference in particular applies to democratic federalism, the current system of decision making in the EU. Majority rule decision making is inherently unstable. It may cycle from one majority to another without reaching an equilibrium. To cope with instability, member states may revert to the “I’ll-scratch-your-back-if-you-scratch-mine” legislative norm of deference to make decisions. ‘Under this norm locally beneficial but centrally inefficient government policies will be approved’ (Inman and Rubinfeld, 2002, p7).

The negotiation process among countries may also manifest itself in an overly detailed system of coordination. For instance, in 1997 France refused to sign the Stability and Growth Pact unless the EU would also start an employment strategy. Over time the employment strategy evolved into 18 employment guidelines in four pillars (employability, entrepreneurship, adaptability of business and employees and equal opportunities). An elaborate EU system of guidelines, recommendations and committees may be at odds with the proportionality principle.

An other consequence of deference may be that countries formulate rather broad and vague goals or policies, so as not to interfere with each other’s domestic policies. That may either give much autonomy to central institutions to define the policy actions. Or, more probable, it may reduce the effectiveness of common policies, because it is unclear what is really meant. In particular when countries put each other to the test in a process of peer review, vague phrases may be a way out. Guidelines for individual member states frequently contain phrases such as ‘promote more adaptable and innovative work organisation’ or clauses like ‘where appropriate’.

According to Pisani-Ferry and Sapir (2006) the mid-term revitalisation of the Lisbon strategy did not succeed in solving these problems. Resistance by the large member states against naming and shaming had country specific guidelines replaced by ‘no less than’ 24 general guidelines. Each of these guidelines is being applied to all member states, without distinguishing whether some may be more relevant for a country than others.

4.2 Conflicts of interest: common pool problems

Discarding policy uniformity (assumption 2 in section 2.1), conflicts of interest are an important reason why centralisation may be at odds with preference matching. Representatives in the legislature are primarily answerable to voters in their constituency or region and care less about voters in other regions (Lockwood, 2005). Depending on the modelling of the voting process and bargaining in legislation, the literature identifies several consequences of these conflicts of interest.

An important drawback of centralisation under democratic federalism is common pool budgeting or raiding the commons (Inman and Rubinfeld; 2002, Oates, 2005). Member states have an incentive to draw as much as possible on the common budget for projects that locally provide benefits. In that way other states co-finance these projects, whereas the benefits mainly accrue to local constituents. EU agricultural policy, cohesion policy and structural funds come

to mind here. When considering independent taxation capabilities at the EU level, common pool problems have to be taken into account as well (Rattso, 2003).

The common pool problem also creates a bias in the selection of projects funded by the legislature (Lockwood, 2002, 2005). When there is cost sharing (for instance through the current GDP-proportional contributions to the EU budget) the legislature has an incentive to minimise the costs of projects, not to maximise their net welfare gains when these are unevenly distributed among member states. The reason is that all member states benefit from cost reductions, whereas only one or a few member states reap the economic surplus of the projects. To some extent this effect may offset the deference problem that creates a bias towards projects beneficial to individual member states (see section 4.1).

Finally, cost sharing of local public goods may induce over-provision of public goods in a centralised system (Besley and Coate, 2003). Cost sharing creates an incentive for local voters to strategically delegate by electing representatives with high demand for public spending. If one region elects a delegate to the legislature who places high value on the public good, this delegate will be more aggressive in demanding a higher public good for that region. That benefits citizens from that region, because part of the costs is borne by the other regions. But if all regions act that way the total amount of public goods will be higher than their efficient levels. In contrast to the previous project selection effect, strategic delegation may exacerbate the deference problem.

4.3 A shifting trade-off

Democratic federalism introduces several inefficiencies associated with centralisation. An attitude of deference among the representatives in the legislature may result in approval of inefficient policies and projects, such as transfers that benefit specific regions. Common pool problems may also lead to over-supply of public goods at the central level. In contrast, the project selection effect associated with cost sharing may make the central government less sensitive to tastes of the regions. Moreover, in these political economy models of fiscal federalism it is not generally true that the higher the cross-border externalities the higher the welfare gain from centralisation (Lockwood, 2002).

Institutional solutions to these inefficiencies are hard to reach. An option is to reform the legislative process, for instance by increasing the power of the Parliament or giving veto rights to the executive (Inman and Rubinfeld, 1997, p52; 2002, p7). That will be a rather delicate topic in the context of the EU. Alternatively, adjustment of the institutions of federalism might change the system of direct representation of member states. In that case groups of local jurisdictions would elect one representative, which might reduce deference. However this comes at the cost of less preference revelation: one representative has to internalise all preferences of several jurisdictions.

With institutional solutions out of reach, these drawbacks of centralisation have to be taken into account when contemplating centralisation of a specific policy or not. In some cases inefficient centralised policies may not outweigh the benefits of internalising cross-border externalities or achieving economies of scale. For instance, considering an independent taxation authority for the Union, Rattso (2003) states that an intermediate situation of broad fiscal responsibilities together with a weak centre is the worst case. It is inferior both to the current situation of a weak centre with limited fiscal authority and the alternative of a politically strong centre with a broad fiscal mandate. Hence, subsidiarity assessment has to take into account these weaknesses of centralisation related to the political process of decision making in the Union.

5 Dynamics affect the centralisation trade-off

European integration is a dynamic process. The optimal level of centralisation in the Union may shift over time. In the past various developments, such as increasing pressure on the environment, have called for a coordinated response. In the future several trends (see De Mooij and Tang, 2003) may affect the balance between centralisation and decentralisation in Europe.

Globalisation is a case in point. Increasing interdependencies in international trade may raise the weight of a common European position in WTO negotiations. Stronger foreign direct investment can increase cross-border externalities when countries try to attract subsidiaries of multinational companies. Large migration flows might affect the spillovers of income taxation and social policy. If labour mobility within the EU increases, the assessment of subsidiarity regarding European coordination of immigration policy might be affected. Although at present there are no signs that labour mobility in Europe will rise substantially, one important reason for this low mobility seems to be the barriers that the European Union itself maintains. Indeed, as long as labour mobility is trivial, the possible spillovers won't be relevant either.

Over time the trends may affect the trade-off between centralisation and decentralisation. They may intensify (diminish) external effects and economies of scale and thus may add to (limit) motives for EU policies. Or they may affect other aspects of the trade-off, such as lobby intensity or government failures. As is discussed in section 3.5, complementarities may call for centralisation in a specific policy field, once another has been centralised. The creation of the European Monetary Union and its implications for other policy areas is a case in point. Furthermore, the decision making process in the European Union is subject to changes. When the decision making process is altered, the assessment of subsidiarity may shift for specific policies, for instance because government failures manifest themselves in another way. The bottom-line of this discussion is that assessing subsidiarity is no static exercise.

Finally, the dynamic process may be asymmetric. Although theoretically it is no problem to change the degree and form of centralisation, in practice a decision to centralise certain policies in the European Union may be hard to reverse. That means the decision to centralise has to be taken with care not to lose the option value of waiting.

6 Conclusion: assessing subsidiarity

This paper has presented many arguments that relate to the degree of centralisation of policies in the European Union. Table 6.1 presents an overview. The table starts with the basic trade-off that underlies the functional subsidiarity test from section 2.4. In that trade-off centralisation is warranted when increasing returns or cross-border externalities outweigh preference matching.

Table 6.1 Subsidiarity: motives for decentralisation and centralisation		
	Decentralisation	Centralisation
Functional test	Preference matching	Increasing returns Cross-border externalities
Political economy		
Leviathan	Accountability, policy competition	Effective monitoring by member states
Lobby	Aligned objectives of lobby groups	Contrasting objectives of lobby groups
Policy learning	Experimentation	Information exchange, commitment for reform
Second best	Offset centralised government failure	Offset decentralised government failure
Deference	Prevent over-provision of public goods	
Common pool	Prevent raiding the commons	
Dynamics		
Trends	----- Affect motives over time -----	
Dynamic process	Centralisation may be irreversible	

The table shows that several political economy motives affect the assessment of subsidiarity as well. Decentralisation provides opportunities for citizens to make governments more accountable to their preferences, which together with policy competition may discipline Leviathan governments in member states. Effective monitoring by member states may counter government failures at the EU level and in that way supports centralisation. The sensitivity to lobbying depends on whether objectives of domestic and foreign interest groups are aligned or contrasting. If they are contrasting, centralised policies are less affected by lobbying. Policy learning benefits from experimentation among decentralised authorities and from information exchange and commitment building at a central level. Centralisation may be useful to offset local government failures and vice versa. Finally, concerning decision making at the centralised level two main risks have been identified. Overprovision of locally beneficial public goods may result, when decision making takes place under a norm of deference. Common pool problems arise, when member states take advantage of the common budget. Hence, decentralisation may prevent these inefficiencies of centralised decision making.

All these considerations may have dynamic aspects as well. Trends may imply that the subsidiary assessment of tomorrow differs from that of today. In addition, centralisation is often practically irreversible.

What general picture do all these pro's and con's yield? Clearly, the basic trade-off occupies an essential place in the assessment of subsidiarity. Any serious assessment of subsidiarity has to start with identifying the existence of increasing returns and cross-border externalities and weighing them against the heterogeneity in the member states. This functional subsidiarity test remains an indispensable tool to make the main arguments pro and contra centralisation explicit.

However, there may be good reasons for the final subsidiarity test to differ from the functional one. Analysing political decision making is important to further understand the trade-off between centralisation and decentralisation (see Besley and Coate, 2003). At the same time allowing for government imperfections and political economy considerations, makes it difficult to draw general normative conclusions on the appropriate degree of centralisation (compare Persson *et al.*, 1996). Because all considerations are case specific, issues of subsidiarity can only be assessed on a case-by-case basis. By consequence a thoughtful answer to the question whether to centralise or not, would demand case-specific careful empirical analysis.

The decision to centralise policies in Europe or not is a complex one. Analysts have to weigh all the partly conflicting motives carefully. What the assessment of subsidiarity would entail is to express all arguments in an open debate. This paper has provided a possible framework to do exactly that.

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