

# Sub-State Entities within the EU: Experience, Economics and Enlargement<sup>1</sup>

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*Eskualdeen arteko desberdintasunek autonomia eskakizunak sor ditzake: eskualderik pobreenak mendekotasunaren beldur dira, aberatsenek transferentziak egiteari uko egiten dioten bitartean. Baina federalismoaren ezaugarri ekonomikoek diseinu arretatsua behar dute, diru sarrerek batzea sustatzeko modukoa. Aurrekontu muga gogorrek begiratzean datza erronka, are Egonkortasun eta Hazkunderako Egiunearen baitan ere. Entzute handikoak dira barne egonkortasunerako egiuneak; baina baliteke aginpide txiki askoren herrietan oinarrituagoak diren ikuspuntuak beharrezkoagoak izatea.*

*Giltza-Hitzak: Estatu azpiko erakundeak. Federalismo fiskala. Erregionalismoa. Egonkortasun eta Hazkunderako Egiunea.*

*Las disparidades regional pueden ocasionar exigencias de autonomía: las regiones más pobres temen la dominación mientras que las más ricas se resisten a las transferencias. Pero las características económicas del federalismo precisan un diseño cuidadoso, que promueva la convergencia de ingresos. Un reto consiste en preservar duras limitaciones presupuestarias, incluso dentro del Pacto de Estabilidad y Crecimiento. Los pactos internos de estabilidad son populares; pero puede que sean necesarios enfoques más basados en el mercado en países con muchas pequeñas autoridades.*

*Palabras Clave: Entidades sub-estatales. Federalismo fiscal. Regionalismo. Pacto de Estabilidad y Crecimiento.*

*Les disparités régionale peuvent occasionner des exigences d'autonomie: les régions les plus pauvres craignent la domination cependant que les plus riches se refusent aux transferts. Mais les caractéristiques économiques du fédéralisme ont besoin d'une soignée conception, qui encourage la convergence de revenus. Un défi consiste à préserver de dures limites budgétaires, y compris dans le Pacte de Stabilité et de Croissance. Les pactes internes de stabilité sont populaires; mais il se peut que des approches basées plus sur le marché dans des pays avec de nombreuses autorités soient nécessaires.*

*Mots Clé : Organismes sous-étatiques. Fédéralisme fiscal. Régionalisme. Pacte de Stabilité et de Croissance.*

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1. This comment discusses two presentations made at a seminar on *Sub-state Entities and Co-Sovereignty within the European Union*, hosted by the European Studies Centre, St Antony's College, Oxford, on 20th May 2004. Max Watson is a Fellow of Wolfson College, Oxford, and an economic adviser to the Directorate-General for Economic and Financial Affairs of the European Commission. This contribution is made in a personal capacity, and in particular does not represent the views of the European Commission.

These presentations raise timely issues about the role of sub-state entities in the EU, and possible implications for the new Member States. One question they prompt concerns the challenge to policy-makers regarding economic development in sub-state entities. What policy approaches promise to foster robust growth and job creation, and accelerate convergence in less advanced areas? This issue is crucial for the longer run health of sub-state entities – but it could also be one of the keys to a new dynamism in the broader EU economy. Only with a stronger performance in less advanced areas will the EU become a zone of growth and high employment – rather than a chequer-board whose average levels of income and employment are destined to remain disappointing.

The economic identity of sub-state entities is grounded in history, but must be continually reinvented. Benedict Andersen taught us to think of nations as “imaginary communities” and the same is true for sub-state entities. Moreover, the *economic* vision that takes hold in these entities may influence strongly their longer-run autonomy and viability. In recent EU experience, three elements can help shed light on this: the economic influences on sub-state autonomy; the nature of internal fiscal settlements in states; and policy approaches that fostered broadly based economic convergence within state economies.

### **ECONOMIC INFLUENCES ON THE EMERGENCE OF SUB-STATE AUTONOMY**

Together with purely political factors, a key economic influence on sub-state autonomy emerges from recent EU experience: the unevenness of income and employment across sub-state entities. This is a factor that will resonate in many of the new Member States, which feature striking local variations in income and employment.

But the influence of such disparities on the emergence of policy autonomy at the sub-state level is complex. *A priori*, the need to tackle inequality might seem to argue against divisions below the state level, which might impede factor mobility. And certainly some unitary states with strong policies (Denmark, Ireland and the Netherlands, for example) have seen their regional disparities decline substantially over recent decades in the context of robust growth and job creation in the wider economy. But in countries where employment growth has been problematic, regional imbalances have had the potential to exacerbate tensions, and thus intensify pressures for greater sub-state autonomy. The experience of Belgium and Italy, for example, is striking in this regard.

In such cases of sustained regional imbalances, economic tensions can run in two directions. Less advanced areas may see state policies as catering insufficiently for local needs – for instance, in terms of investment or training. Symmetrically, more prosperous areas may resent the fiscal transfers implicit in different tax yields and unemployment transfers. This latter reaction can be seen clearly in prosperous areas such as Flanders or northern Italy in the 1980s and 1990s. Together with other factors, it contributed to pressures for greater sub-state economic autonomy in those cases – and in Belgium the result was a major change in economic roles.

In the new Member States, such underlying economic factors may prove as important, over time, as policy-driven influences such as mechanisms for disbursing EU structural funds. But pressures are one thing, and performance is another: policy autonomy, to deliver growth and jobs in a stable economic setting, needs to be carefully managed...

## **‘FISCAL SETTLEMENTS’ BETWEEN THE STATE AND ITS ENTITIES**

A growing concern in the literature on sub-state autonomy has been the challenge of fiscal co-ordination. Among emerging market economies, the experience of Argentina and Indonesia – where expenditure control was undermined during decentralization – has heightened awareness of this problem. If decentralization ends up by jeopardizing economic stability, it risks killing the golden goose of private sector confidence.

Such adverse experience is sometimes used to argue against decentralization. But that pre-supposes decentralization to be an *option*. Its political-economic roots, however, may run deep – and if so, fiscal tensions could be as serious in its absence. The case evidence is useful, rather, in illustrating the risks of badly-designed decentralization. For success, it is crucial to address tensions *ante*, through co-operative fiscal settlements that define the rights and responsibilities of the different levels of government. This can ensure adequate resources, but also hard budget constraints, for sub-state entities.

For the “old” and new Member States of the EU, of course, fiscal co-ordination has a particular formal importance because of the goals embodied in the Maastricht criteria for euro area entry and the Stability and Growth Pact. And recent years have seen continuous experimentation with internal co-ordination in some Member States.<sup>2</sup> Three cases deserve mention, at least by way of illustrating how some EU members have been wrestling with this issue. It is notable that the two of these that are most decentralized – Belgium and Spain – have ended up adopting formal or informal “internal stability pacts”.

- In Belgium, a series of negotiations over the past two decades achieved the transition from a fiscally unitary to a fully federal state. The structure is complex (in part because regions and language communities are distinct). And the negotiations had to address deeply-rooted problems. But it is notable that this period also saw a dramatic turnaround in the public finances, setting Belgium’s debt on a declining trend and clearing the way to euro area membership. This was based on strong co-ordination of fiscal goals between the levels of government, supported by the work of a specific body: the High Council of Finance.

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2. Some countries, despite minor innovations, retained a quintessentially unitary structure. At the other extreme, Germany was founded, of course, as a fully-fledged federal state – but even there recent years have seen considerable debate about the effectiveness of its internal federal fiscal arrangements.

- Spain has wrestled with issues of fiscal decentralization, adopting over time a variable geometry that reflects the imprint of history on its various autonomous communities. Again, this challenge did not impede fiscal consolidation. But the authorities have now moved to a legally-based internal pact enforcing budget balance at all levels of government: experience is still being gained with the *Ley de Estabilidad Presupuestaria* that was enacted at the beginning of this decade.
- The United Kingdom is generally regarded as a fiscally unitary state, because a high share of revenues are gathered centrally and then redistributed. The constitutional innovations of the past few years – giving differing measures of autonomy to Scotland and Wales – nonetheless show experimentation, and represent a learning experience that, again, is still underway.

Currently, as indicated by Elena Jurado, fiscal decentralization has not been strongly catalyzed in the new Member States by the EU integration process – although it is somewhat more evident in Hungary and Poland than elsewhere.<sup>3</sup> To the extent decentralization does take root in these economies in due course, two administrative issues are likely to come to the forefront.

The first, along the lines discussed above, is indeed the priority of ensuring *firm control over public spending*. The new Member States are grappling with important challenges in supporting reforms, restructuring expenditures, and revising tax bases to reduce over-dependence on labour income. The far-reaching nature of some reforms – for example, the privatization of local services – will itself change the whole accountability landscape for local issues in the period ahead. While managing these tasks over the next few years, policy-makers might be well-advised to contemplate the added dimension of further decentralization only if this is politically essential; and, if so, then to adopt approaches that guarantee hard budget constraints. Otherwise there may be risks of crowding out private sector development – and thus damaging the motor of real convergence.

The second issue concerns the *philosophy of fiscal discipline*. In principle there are two “corner solutions:” internal stability pacts, or market-based systems under which local authorities face rating disciplines and risks of bankruptcy. Thus far, EU experience in has been essentially in the former direction (as cited above). But this probably presupposes a modest number of major regions, with whom negotiations can tractably be held – a situation which does not currently prevail in all the new Member States. This is a complicating factor that needs to be weighed carefully in their situation. On the other hand, if stability pacts are adopted, these should allow fiscal stabilizers to work, which implies avoiding simple balanced-budget rules that could force tax increases or spending cuts in a recession – an unfortunate feature in some such existing internal arrangements.

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3. It is also possible that the Copenhagen emphasis on non-discrimination against minorities may have helped counter some factors that could otherwise have led to early calls for greater policy autonomy.

## ECONOMIC PHILOSOPHIES AFFECTING THE SUB-STATE LEVEL

Examining cases of decentralization across the EU, a wide range of economic issues can be found assigned at the sub-state level – ranging from property taxation to aspects of foreign economic relations. Nonetheless, when once considers key policy influences on growth and employment, some are not found at this level. Belgium – strongly federal by any standards – nonetheless has social security policies as a state (central) function, and the design of these policies clearly influences incentives in the labour market. So it is helpful to consider first, irrespective of administrative level, what policy approaches may be friendly to economic growth and convergence. This will provide a basis to reflect on possible policy approaches at the sub-state level – but also on the kind of feedback these entities may need to deliver to state or EU levels as regards wider policy approaches.

A classic contrast in convergence experience (internal and external) has been noted by many commentators in Ireland and Italy. A degree of consensus has emerged that Ireland was more successful because it placed much stronger emphasis than Italy on avoiding subsidies to declining industries, on ensuring bureaucratic transparency in decision-making throughout the territory, on facilitating inward direct investment, on fostering high standards of education, and on fostering a fairly flexible labour market – all this in a setting of macroeconomic policies that strongly turned around private sector confidence.

No doubt reflecting these factors, Ireland has experienced very rapid internal and external convergence over the past two decades. In Italy, growth and employment performance lagged across the economy on average, and one key reason lay in the poor progress that was made in fostering catch-up in the *mezzogiorno*. This comparison may be of particular interest for the new EU Member States, because regional aid from the EU in both these cases has been generous – but associated with very differing degrees of success.

In Ireland and Italy, most of the policy domains cited above were in fact at the level of the state. But another valuable example is to contrast *within* the state of Belgium the policies toward structural change adopted from the 1970s at the sub-state level in Flanders and Wallonia. Flanders' economic take-off since that time reflected, no doubt, many influences – including an economic structure at the time of the oil shocks that featured less energy-intensive sectors. Wallonia, by contrast, languished: unemployment remained very high. Among the key factors underlying this contrast appear to have been differing attitudes to support for declining industries, and poor responsiveness of local labour market conditions, including wages, to employment trends. Important also is that a fundamental dilemma emerged in Belgium: under fiscal autonomy, but with weak structural policies, less advanced areas now have less resources avail for training or infrastructure investment... Fiscal autonomy without structural economic reforms can be a recipe for divergence among sub-state entities.

Is the experience of southern Italy or Belgium unrepresentative of sub-state development in the EU economy? Unfortunately not. Germany, too, has expe-

rienced major difficulties in fostering regional convergence – and this is true in a minor key in the western Länder, not just the east. Experience in Spain has been mixed. As a broad generalization, the literature suggests that regional convergence in western Europe was rapid in the 1950s and 1960s, but slowed – and in some cases stalled – from the mid-1970s onwards. Given the lower income levels, and wide disparities, in the new Member States, it would be dramatic if they now found their internal convergence similarly arrested.

To the extent this is true, then sub-state authorities – where policy-makers are most directly faced by the tensions of weakly performing areas – are likely to focus strongly on this issue in the period ahead. At their own level, they can foster training and economic renewal, rather than perpetuate declining industries – where they have the instruments to do this. But they may well be led also to seek policy reform at the state and EU levels: to urge approaches that would help foster strong convergence within and among Member States. The experience of Italy and Ireland, cited above, is strongly suggestive about the direction of required structural reforms – which would need to be market-friendly, outward-looking, and couched in a setting of credible macroeconomic policies.

## **CONCLUSION**

In sum, fundamental economic choices lie ahead in the enlarged EU, including notably its new Member States – and such choices could be influenced by crucially by sub-state entities...

A pessimist might imagine backward areas within the member states sliding toward a culture of dependency – lobbying their governments, and Brussels directly, for subsidies to cushion the costs of disadvantage. Enlargement and enhanced competition would become engines of discontent. Social protection, on this model, might be devoted to minimizing wage differentials and ensuring high replacement rates for benefits. Hours would be shortened. And immigration within and from outside the EU – like part-time or temporary employment – might be seen mainly as threatening a fixed lump of jobs. But with enlargement, and with potentially dynamic economic relations with the EU's new eastern neighbours, the scope for more benign outcomes is clear. Indeed, the wide income disparities of the enlarged EU make it politically essentially to find ways of tapping this potential for strong growth and job creation.

Sub-state entities, if they are vocal, can help in spearheading this process. But to do so effectively they must be prepared to revitalize their economic structures, and think in terms of a variable geometry of economic identity. Sub-state entities may develop close links across the borders of new Europe – linking areas not only in Sweden and Finland, for example, but in Germany and the Czech Republic, or Italy and Croatia.

By guaranteeing free cross-border movement of goods (and, one day, of labour), the EU enhances these possibilities. Moreover, the freedom of capital movements within the EU can allow sub-state entities to specialize more strongly

– because they can moderate the income risks of households through investment in other areas. In the United States, the strength of local specialization is doubtless linked to the fact that states diversify some two-fifths of their GDP shocks through the income they earn on out-of-state assets.

So the vision would be of outward-looking sub-state entities, welcoming the movement of capital and labour. To realize it requires, very clearly, much faster structural reform in the EU, along the lines of the Lisbon agenda... But, as discussed above, it also requires co-operation and policy learning among the EU, state, and sub-state levels about the structures and changes needed for growth, and the way autonomy plays into this nexus.

Such a vision holds the potential, of course, for rapid convergence of less advanced areas within the EU. But for the wider geographic Europe, too, it promises a dynamic future.