

State of the Union/ By Jonathan Rodden

A Taxing Fight Over Regionalism

Among Europe's wealthier regions, American-style competitive federalism is suddenly all the rage. Northern Italians and Baden-Wuerttembergers are tired of subsidizing their less prosperous neighbors through national tax-transfer policies. Policies that a generation ago seemed to promote a national market and a healthy sense of unity now seem like wasteful *Gleichmacherei* (a pejorative German term for equalization) that dampens incentives for efficiency and innovation among regional governments.

Why now? Trade integration and political devolution—two of the most pronounced trends in governance around the world in recent decades—make the old powerful central governments in Berlin, Madrid and Rome look less attractive. Pressure to devolve power to regions is on the rise. And the backlash against centralization involves not only local nationalism or wounded pride--but also money.

So political entrepreneurs in Bavaria, Baden-Wuerttemberg and Northern Italy are demanding more taxes be legislated, collected and spent locally, in turn reducing the net transfer of resources to the Italian South, the German East, and poorer West-German regions like Saarland. In a brave new world of competitive federalism, they argue, we'd get less tax evasion, improved schools and public services, and fiscal discipline. It would make governments more directly accountable to their voters. And in the long run fiscal decentralization would be for the good of the poorer regions. Like the American South, they'd be forced to come up with innovative strategies to attract and retain mobile capital.

The new European federalists don't want to push the U.S. analogy too far given its political and ideological implications. And in any event, most German and Italian devolution advocates are interested more in reducing inter-regional transfers than in any elaborate philosophy about federalism, democracy and economic development. Yet if it succeeds, this "devolution" would push Europe toward a very distinct federal philosophy.

At least since Friedrich von Hayek, fiscal conservatives have idealized competition over mobile capital in a federation with a common internal market and decentralized taxation as a way to restrain the growth of government and keep socialism at bay. For social democrats--already fearful about the constraints placed on the welfare state by international tax competition--fiscal decentralization within countries poses a direct threat. Fearing capital flight or in-migration of welfare recipients, regional governments would be forced to avoid high taxation and generous welfare benefits. The wealthy would be able to cluster in exclusive communities and avoid paying to educate the children of the poor.

In short, Europe would begin to look more like the United States.

Will this come to pass? Probably not. Fights about fiscal devolution often turn into rather old-fashioned battle between wealthy and poor regions. The problem for the new devolution zealots lies in Aristotle's observation that "the rich everywhere are few, and the poor numerous." As explained by economic geographers, most countries have one or two industrialized "cores" and larger, less developed hinterlands. Many Europeans, especially in the periphery, perceive that trade integration implies heightened risk. Their demands for the insurance and redistribution provided by central governments have not waned. Poor regions are often well positioned to protect their transfers when threatened by activists in the wealthy regions.

Take the German federation. Only five of the states pay into the fiscal equalization system and 15 are net recipients. Changes to the German fiscal constitution require a super-majority of states, and it is difficult to imagine why the median recipient state would vote away its subsidies. In the most recent renegotiation of the German system last summer, the wealthy states appeared to be driving a hard bargain, demanding American-style tax autonomy and significant reductions in the share of their receipts subject to sharing with other states. The poorer states, however, could easily veto any proposal that would lower their receipts. Yet Chancellor Gerhard Schroeder announced an agreement in which, miraculously, everyone was proclaimed a winner.

How was this achieved? The wealthy states didn't gain significant autonomy to set tax rates, but were placated by a reduction in the amount they're required to transfer directly to the poor states. In order to get the poor states on board, Berlin promised to fill the gap with new federal transfers. Most of the states will as a result actually be more dependent on the federal government.

This is not an isolated example. Of all the high-profile decentralization reforms around Europe, precious little has taken place on the revenue side. New layers of government have been created, new parliaments convened, and significant responsibilities transferred to existing regional and local governments. But most of this is funded through increased intergovernmental transfers or shares of taxes that are levied and collected by central governments. While demands for "devolution" and "decentralization" are mainstays of electoral politics throughout Europe, only a handful of wealthy jurisdictions actually want the central government to devolve tax powers to the region or local authority.

For most local governments, devolution means more money with fewer strings attached, raised elsewhere and collected by others. In France, tax autonomy of local governments has declined and dependence on intergovernmental transfers increased. The devolution program in the U.K. has been funded entirely by transfers from the central government. Scotland has the option of altering rates but has declined to do so. Tax decentralization has gone somewhat further in Italy, but the vast majority of what appear to be new "taxes" for the regional governments are actually shares of taxes levied by the center, or the right to levy small additional surcharges on such taxes.

Devolution in Europe might lead to something quite different from Hayek's world of lean, competitive, accountable regional governments. In much of Europe, more layers of government are growing increasingly intertwined in a complex web of fiscal relations. Some local governments have more responsibilities, but the money still comes directly from Rome, Berlin, Brussels, or increasingly, complex intergovernmental tax-sharing agreements.

But let's avoid simple generalizations about the future of governance in Europe. Tax decentralization has gone very far in the Spanish Autonomous Communities and appears to be keeping pace among the Belgian regional governments. Perhaps this should not be surprising. Especially in Spain, the driving force behind tax decentralization has come from regions that are not only wealthy, but also culturally distinct and able to make much more credible secession threats than, say Bavaria or Lombardia. There's no evidence of homogenization across Europe. Even within Scandinavia, Swedish local governments have a long tradition of tax autonomy while their Norwegian counterparts virtually none.

Recent decades have seen remarkable changes. The power to print money was delegated upward and some of the power to spend downward. Yet with a few notable exceptions, central governments have been slow to let go of their power to tax. One thing seems certain: battles between wealthy and poor individuals and regions will not disappear in a more integrated Europe. And the winners and losers in these battles will have implications for the future of European governance.

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