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SUBSIDIARITY, GOVERNANCE, AND EU ECONOMIC POLICY

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DANIEL L. RUBINFELD**

For reasons largely related to ensuring long-run national security and political stability, the nations of western and central Europe, and perhaps soon the new democracies of eastern Europe as well, have banded together to form an economic federation: the European Union. Recognizing that economic interdependency is often the best deterrent to destabilizing political or military interventions, the Union's member nations have, since the initial 1951 Treaty of Paris, moved steadily forward to a fully integrated European economy.

To ensure the efficient performance of this wider economy, uniform rules of commerce, fiscal harmonization, and integrated public infrastructures will be required. Deciding and then enforcing these union-wide regulations and fiscal policies will require supranational political and judicial institutions. Economic unions necessarily lead to political unions of some form, and political unions require clearly articulated, and perhaps constitutionally protected, principles of policy assignment and governance. Who should be responsible for economic policy (assignment), and how should policies be decided (governance)?

The European Union's guiding principle for assignment, now constitutionally grounded in the Maastricht Treaty for the European Union, is subsidiarity, the allocation of policy responsibility to the lowest level of government at which the objectives of that policy can be successfully achieved. The Union's principles of governance are still evolving, having swung pendulum-like from an early period of unanimous rule under the 1957 Treaty of Rome to a period of *de facto* executive control following the adoption in 1986 of the Single European Act. Today, the Union is searching for a middle ground stressing governance through co-decision-making between two majority rule legislatures, the Council of Ministers and the European Parliament.

The Objectives of Federal Constitutions: Constitutions establish the rules for collective decision-making: who is allowed to participate, what is to be decided, and how policy decisions are to be reached and enforced. The unique contribution of a *federal* constitution is to allow for multiple tiers of governments, each with a domain of policy responsibilities. In setting the number and layers of governments and in drawing their exclusive and mutual responsibilities, three objectives for government are commonly mentioned: to guarantee personal, political, and economic rights; to encourage political participation; and to promote the efficient allocation of economic resources.

Protecting Rights: Personal, political, and economic rights define the domains of individual liberty. Liberties may be either "negative" or "positive." Negative liberty ensures that individuals are free from interference of others in certain choices and actions; positive liberty guarantees each individual an ability to make certain choices or to perform certain actions. Religious rights, voting rights, the right to speak freely, and property rights guard matching negative liberties. A right to minimal subsistence and shelter, to education, or to health care provide protection for corresponding positive liberties. Governments in turn protect rights. A citizen Bill of Rights joined with a credible and independent judiciary is perhaps the most important institutional guarantor of individual rights and thus liberties. Separation of powers between branches of the central government joined with credible checks and balances across those branches offers

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further protection. Federalism is a possible third line of defense; see Rapaczynski (1986).

Encouraging Political Participation: Political participation is how ordinary citizens influence or attempt to influence political outcomes. The lack of such influence constitutes a "democratic deficit." Jeremy Bentham and James Mill saw political participation as a way to ensure that governments maximize aggregate citizen utility or welfare. Jean-Paul Rousseau and John Stuart Mill stressed how participation helps to protect citizen liberties; active political participation in a democratic society ensures no one individual or group is master over any other. Aristotle and Alexis de Tocqueville noted political participation's important contribution to encouraging communitarian values. By giving an important role in policymaking to subnational governments, particularly local governments, the federal form of governance encourages political participation; see Dahl and Tufte (1973).

Constitutions establish the rules for collective decision-making

Promoting Economic Efficiency: Economic efficiency requires that no reallocation of union resources can make one person or group within the union better off without hurting another person or group. Competitive markets and free trade will move a union a long way towards economic efficiency, but unencumbered markets alone cannot guarantee economic efficiency. Markets fail for a variety of reasons: public goods, spillovers, increasing returns to scale, asymmetric information. In each of these instances, efficiency requires cooperation to overcome the market failure, but the cooperative provision of a good or service often creates strong incentives to conceal true benefits and to free-ride. "Let the other fellow contribute – I don't really want that service anyway!" The federal form with its possibility for competition between lower tier governments offers a unique means for solving the problems of information revelation and free-riding. National defense and union-wide transit and communication networks are probably best supplied at the highest level of government. Here the federal form of governance has no particular advantage. But for most other public services, competitive state and local governments are more efficient, and thus the federal form of governance can be preferred; see Oates (1999).

The Structure and Performance of Federal Constitutions: Federal constitutions are defined along three dimensions: (1) The *number* of member states included within the union; (2) The *assignment* of policy responsibilities between member states and the union government; and (3) The *representation* of member jurisdictions to, and rules of governance for, the union-wide government. From the Treaty of Paris to the Treaty of Nice, each European Union treaty has made an explicit choice along these three dimensions of a federal constitution. Choices along these dimensions define one of three generic federal constitutional forms, with each constitution likely to have different performance properties against the objectives of rights protection, political participation, and economic efficiency.

Decentralized Federalism: Decentralized federalism combines Charles Tiebout's (1956) model of competitive governments with Ronald Coase's (1960) model of efficient bargaining. The number of subnational or member governments requires that each union member be sufficiently large so as to be able to provide congestible »local« public goods efficiently. Very small or economically inefficient candidate nations should not be allowed to join the union as separate member states. Typical examples of congestible public goods, where more users eventually reduce the benefits enjoyed by previous users, include education, police and fire protection, health care, local roadways, parks, and local environmental quality such as trash collection, clean water, public sanitation. The efficient size of government for the most congestible local public goods is no smaller than 20,000 residents and probably no larger than one million residents. Current and proposed member nations in the European Union clearly meet this constraint.

Assignment under decentralized federalism allocates all policy responsibilities, at least initially, to these subnational or member governments. Member governments may then jointly decide to reassign some or all of their policy responsibilities to a union government.

Governance rules will be required for all policy decisions reassigned to the central government. The decision-making body will be a union-wide legislature with at least one representative from each member government. Unanimity will be the required voting rule in the union legislature under decentralized federalism.

As a protector of individual rights, the performance of decentralized federalism is uncertain. If

individuals are mobile across member governments, if new member governments can be created by citizens of the union, and if member governments have full responsibilities for rights enforcement and policies within their borders, then individual rights to personal freedoms, political rights, and property rights are likely to be well protected. Any citizen who feels abused can relocate to another, presumably safer member state, or perhaps to a newly created member state. But to guarantee mobility and to protect or create states, a strong central government at the union level will still be needed. If free mobility, new government formation, and member independence cannot be guaranteed by the overarching union government, then subnational member governments may become a source of oppression through "tyranny by a majority." U.S. Southern states before the Civil War is one telling example and so too is the recent history of Serbian oppression of Muslim citizens of Yugoslavia.

Decentralized federalism may also fail to ensure positive liberties. If protecting positive liberties requires the taxation of the more able to subsidize the less able – say to provide a subsistence income, basic shelter, or minimal education and health care – then a decentralized network of fiscally competitive member governments is not likely to succeed when economic resources are mobile. The redistribution required for the protection of positive economic rights can be achieved, if at all, only through the efforts of the union-wide government. But under decentralized federalism, union government policies require the unanimous consent of all member states. Positive liberties are likely to be denied, but now through "tyranny by a minority." The U.S. effort to redistribute income and public services through state governments provides strong evidence on the point; see Feldstein and Wrobel (1998).

The likely performance of decentralized federalism in fostering political participation is more encouraging. Available evidence reviewed by Dahl and Tufte (1973) from within country comparisons of political influence and political effort shows that citizens in smaller governments make a greater effort to understand, and have more success in understanding political issues. Further, citizen effort to influence government is two to three times higher for subnational than for national governments. Political effectiveness or influence also increases as the size of government declines; Finifter (1970) shows a significant negative correlation between an index of political power and the size of government. Finally, locally elected legislatures are likely to be the most responsive to citizen preferences (Cain, et al. 1987).

Finally, like the protection of rights, the potential for decentralized federalism to efficiently provide government services is uncertain. Five conditions must hold for a decentralized public economy to be economically efficient: 1) Publicly provided goods, services, and regulatory activities must be available at a positive, but minimal average cost; 2) There must be a perfectly elastic supply of competitive governments; 3) Households and businesses must be fully informed about the fiscal and regulatory policies of each government; 4) There must be free and easy mobility of households and businesses across the member governments; and 5) There can be no significant intergovernmental externalities or spillovers. When any one of these five conditions is violated, union-wide provision of government services or regulations must be considered.

There are three generic types of federal constitutions: decentralized, centralized, and democratic federalism

In decentralized federalism, central government policymaking is done through unanimous agreements among the member states. For successful agreements to occur, five conditions must be met here as well: 1) There must be no, or very small, resource costs associated with the bargaining process; 2) Preferences over outcomes must be common knowledge; 3) Bargaining agents from the member states must accurately represent the economic interests of their constituents; 4) All agreements must be enforceable; and 5) The parties to the agreement must agree to a division of the bargaining surplus. To expect union-wide decision-making to meet these five conditions, particularly as the size of the union grows much beyond four or five members, seems to us to be very optimistic; see Inman and Rubinfeld (1997a).

Decentralized federalism promotes political participation

The assignment and governance structures of decentralized federalism will encourage political participation but, except in very small and homogenous unions, such constitutions are likely to perform poorly against the other constitutional objectives of rights protection and economic efficiency. There are alternatives.

Centralized Federalism: Centralized federalism combines all member governments into a single union-wide government. All policy responsibilities

are assigned, at least initially, to this one central government. The central government is governed by a president or a small executive council elected by all citizens of the union. If the elected president wishes, policy responsibilities may be reassigned to member country governments, whose own executives may be elected locally or appointed by the centrally elected president or council.

Centralized federalism is likely to offer only fragile protection for individual rights. Open and competitive elections of the union executive will protect individual rights and liberties, but when the majority electing the executive forms a stable political "monopoly,"either because of fixed and aligned economic interests or ethnic allegiances, then minority rights are significantly at risk. The fate of Blacks in the U.S. South before the Voting Rights Act of 1965 or that of Jews in Nazi Germany illustrates the potential risks to basic liberties with stable majority-controlled central governments.

Centralized federalism combines all member governments into a single union-wide government

Nor is centralized federalism likely to enhance the goal of political participation. All policy responsibilities are assigned to the central government. Smaller member governments are arguably the more participatory, yet they run the risk of becoming no more than administrative agencies of the central government. Nor is political participation at the union level of governance likely to be very great, limited as it is to the election of a single executive or oligarchy.

The goal likely to be best encouraged by centralized federalism is economic efficiency. Here a democratically elected executive sets policies for the nation as whole. For these policies to be efficient, however, the executive must first reveal citizen preferences, and then choose efficient policies after citizens' preferences are known. The burden for finding an efficient resource allocation falls to the election process. If elections are open so that any citizen can run for the presidency, then policies chosen by the president will be efficient in two-candidate elections; see Besley and Coate (1997). The intuition is straightforward. In two-candidate elections, citizens vote truthfully. Thus, any efficient candidate can propose a policy which a majority of voters prefer and which defeats any policy proposed by an inefficient candidate. Open elections with informed voters are essential, however.

Democratic federalism combines the advantages of both other forms

In the end, the overall performance of centralized federalism will be at best mixed. Competitive democratic elections of the union-wide executive are likely to foster overall rights protection, but monopoly control of the executive raises a significant risk of rights abuses. Political participation is likely to be discouraged; a "democratic deficit" results. The one virtue of centralized federalism is its potential for efficient resource allocations when elections are open and voters are informed.

Democratic Federalism: Democratic federalism offers a promising middle ground, joining the ability of decentralized federalism to protect rights and promote participation with the economic efficiency advantages of centralized federalism. As in decentralized federalism, member states in the economic union must be of sufficient size so as to provide congestible public services efficiently. Constitutional assignment allocates policy responsibilities to member states or to the union level of government by a principle of subsidiarity – that is, member governments are allocated those policies which benefit local populations and which have no significant positive or negative spillovers onto nonresidents. For goods with significant economies of scale in production or consumption, for taxes which alter the spatial allocation of economic resources, and for services and regulations with economic spillovers, allocation by the union government is preferred. Finally, governance within democratic federalism gives each member state a clear voice in the central government through direct representation in a locally elected union-wide assembly. Decisions in the union legislature are made by simple majority, or perhaps supermajority, rule.

Assignment of important taxing and policy responsibilities to the lower-tier member states will make an important contribution to ensuring personal, political, and economic liberties. For example, assigning significant taxing powers to subnational governments controls unwanted taking of private property by government; see Weingast (1995). Assigning member governments responsibility for police functions ensures that local residents can monitor and discipline any abuses of police powers and provides possible protection against armed interventions by other local or even national interests; see Rapaczynski (1986). Education too can be assigned locally to ensure political rights and freedom of speech. The union government can then be given responsibility for ensuring minimal economic subsistence, access to clean and safe shelters, lit-

eracy, and basic health services; see Sen (1988). Finally, a representative legislature run by majority rule checks tyranny by a stable minority, while wide representation of local interests minimizes the risks to rights arising from a stable majority; see Madison's Federalist 10 (1787).

Political participation is likely to benefit from the introduction of democratic federalism, but again only if member state governments are given significant policy responsibilities. Furthermore, the union legislature must allow for significant representation of member state interests in its deliberations.

The efficiency performance of democratic federalism also rests fundamentally on the constitutional rules of assignment and governance. Efficient assignment limits central government responsibilities to those activities which entail significant externalities across the member states. Efficient governance must solve the inherent policy instability found in any majority-rule legislature but must do so in a way which retains an alignment of member states' benefits and costs from union policies. There is a significant risk that legislators from member countries, when faced with the problem of policy instability, will find a legislative norm of deference – more commonly characterized as "I'll-scratch-your-back-if-you'll-scratch-mine" – as the only feasible way to make decisions. Under this norm, locally beneficial but centrally inefficient government policies will be approved. If assignment cannot be easily enforced, then local projects funded from the union-wide tax base become part of the union-wide budget. That will be an inefficient budget. Failing effective assignment, strong governance in the form of strong union-wide political parties within the legislature or a strong union-wide executive with veto powers will be needed; see Inman and Fitts (1990). Enforceable assignment and strong governance are essential for economic efficiency under democratic federalism. With appropriate rules of assignment and governance, however, democratic federalism goes a long way towards meeting each of the three objectives for a federal constitution.

The European Union's Search for a Federal Constitution: Beginning with the 1951 Treaty of Paris between France, West Germany, Italy, Belgium, Luxembourg, and the Netherlands establishing the European Coal and Steel Community, to the 1957 signing in Rome of the European Economic Community Treaty (EEC Treaty of Rome), to the Luxembourg Compromise in 1966, to the entrance of Denmark (1973), Ireland (1973), United Kingdom (1973), Greece (1981), Portugal (1986), Spain (1986), and then finally Austria (1995), Finland (1995), and Sweden (1995) into the Community, the nations of western and central Europe have been moving steadily towards an integrated economic and political union. The central driving force both historically and to this day has been the desire of France and Germany to avoid military conflict on the continent. Integrated economies are seen as one crucial means for ensuring political stability in a wider Europe.

With appropriate rules of assignment and governance, democratic federalism is best suited for a federal constitution

Governing the initial steps towards this economic union was a federal constitution best described as *decentralized federalism*. The Treaty of Rome created a variety of supranational institutions akin to a central government, the most prominent of which are the European Commission serving as an executive civil service, the European Parliament serving as an elected (since 1979) legislature but originally with consultative powers only, the Council of Ministers whose final *unanimous* approval was required for all EU decisions, and the European Court of Justice to make rulings on matters of treaty enforcement. Under the Treaty of Rome, the center of power lay with the Council of Ministers composed of one representative from each member state and guided, since 1974, by a complementary body of heads of state called the European Council. Beginning in 1966, the Treaty required a formal change in Council voting procedures, moving the decision-making rule from unanimity to qualified majority. However, a threat by France to withdraw from the Council of Ministers if qualified majority took effect lead the Council to adopt the Luxembourg Compromise to continue a rule of unanimity on all matters of "vital national interest." While not formally part of the EEC Treaty, the Compromise stood as a binding constraint on Council decisions until the passage of the Single European Act in 1986. Prior to 1986, however, only unanimous agreements could become Community policies.

The Treaty of Rome also assigned policy responsibilities to the Council, foremost of which was to create a common market. This the Council did through its power to remove intercountry tariffs and through the promotion of economic competition between firms in member countries. The

Council also assumed responsibility for a Common Agricultural Policy and adopted a variety of price support policies "to ensure a fair standard of living for the agricultural community." In all instances these policies were approved by a unanimous vote of Council members. Also assigned to the Council were transportation policies and social policies. Because of significant disagreements among member countries in these policy areas, however, unanimity was not achieved and little could be accomplished towards the overall goal of economic integration.

Born in part from the frustration over the slow pace of integration and a growing appreciation of the advantages such reforms might have in combating Europe's declining economic fortunes (known as "Eurosclerosis"), the then ten members of the Union put aside the Luxembourg Compromise and the principles of *decentralized federalism* and adopted in 1986 the Single European Act (SEA) and a new institutional structure closely approximating that which we have called centralized federalism. The rule of unanimity was replaced by a »consultation procedure« and a commitment to allow qualified majorities to make substantive policy decisions. Proposals would come from the European Commission as before. Now, however, only a qualified 71 percent majority of the Council of Ministers was needed for a policy to become law. Still the Commission's proposals could be only accepted or rejected; unanimity was required for the Council to amend the Commission proposals. The use of a qualified majority meant no one country could block a policy, while the consultation procedure gave strong agenda-setting powers to the Commission. Together these two reforms moved policymaking into the hands of a single central executive.

The EU's quest for a constitution has gone through several stages

The consultation procedure applied to all policy areas covered by the original Treaty of Rome (agriculture, transportation, social policy, environmental policy, regional and fiscal policies) except for those policies concerned with the completion of the internal market (competition policy, free movement of goods, labor, and capital). For these policy assignments, the SEA recommended a second innovation to Union decision-making called the "cooperation procedure," where policies approved by the Council go to the (now locally elected) European Parliament to be accepted, rejected, or amended by simple majority rule. The cooperation procedure raised the Parliament to the role of a conditional agenda-setter, where an alliance between the Commission and Parliament (a frequent outcome) could force the Council to make decisions on their terms (Tsebelis 1994). Parliament, however, had no original agenda-setting powers under cooperation. Thus, the pivotal institution for policy innovation under the SEA became the European Commission, an executive cabinet appointed by member nations.

The appointed Commission's influence reached its peak in the late 1980's, no more clearly evident than in its 1988 decision to establish a committee under the direction of the Commission President Jacques Delors to explore the feasibility of a European Monetary Union (EMU) as a complement to the increasingly integrated European marketplace. At this time, the European Commission stood as the dominant voice in Union policymaking. Paradoxically perhaps, the approval of the Commission's crowning achievement, the EMU, would begin the significant erosion of its powers and the evolution towards democratic federalism under the Treaty of Maastricht.

The Maastricht Treaty of 1991 created the Economic and Monetary Union, charged to encourage the free flow of goods, labor, and capital and to establish a common monetary policy for all member states through the introduction of a single European currency and a single European Central Bank. Whatever the economic benefits of a Monetary Union, they come at a cost. Member countries sacrifice their ability to use expansionary monetary policy to offset the adverse employment effects of negative economic shocks. If economic shocks affect all or most of the Union's countries similarly, then the EMU's common monetary policy can serve the same role as country-specific expansionary monetary policies during times of deep recessions. But if economic shocks are asymmetric across the potential members of the EMU, as recent experience seems to indicate, then the loss of country-specific monetary policy imposes potentially large costs on members during economic downturns. The costs are likely to be largest in the larger countries of the Union, where domestic monetary policy is most likely to have expansionary benefits during recessions. One response would have been to allow these member countries to run decentralized, country-specific deficit fiscal policies. But Maastricht, as amended by the Pact for

Stability and Growth, denied member countries this policy option. Concerned that economic spillovers from high deficit countries could threaten promised price stability, the Stability Pact imposes a tight 3 percent of GDP limit on country budget deficits.

Facing constraints on their use of countercyclical deficit policies, the member countries introduced yet another revision to EU political institutions. The co-decision procedure, first introduced in the Maastricht Treaty but amended and strengthened by the 1997 Treaty of Amsterdam, elevated the locally elected European Parliament to a legislative coequal with the Council of Ministers. The co-decision procedure now gives the Parliament joint say along with the Council of Ministers over the final specification of EU fiscal and regulatory policies. Policies first rejected or amended by Parliament but once again approved by the Council, perhaps in another amended form, must be returned to the Parliament for reconsideration. Disagreements between the Council of Ministers and Parliament are to be resolved through a Conciliation Committee composed of members from both bodies. The net effect of the co-decision procedure is to create two equally powerful legislative bodies, each capable of blocking the preferred outcomes of the other. Negotiations between a broadly elected Parliament and a country appointed Council have now fully replaced the non-elected European Commission as the focal point of EU policy-making. In its current form, the Union's decision-making structure closely resembles that of the United States: an institutionally weak executive, a state (country-specific) Senate and a district (region-specific) House. The EU constitution is today best characterized as democratic federalism.

Whither EU Policy Under EU Federalism? As the Union expands, there will surely be adjustments to its rules of decision-making, but there now appears a core commitment to the institutional structure of Maastricht and Amsterdam: a weak executive with agenda-setting but no veto powers and two coequal legislative chambers. In response to Union expansion, the 2001 Treaty of Nice proposed changes in the voting rules within the Council of Ministers and an expansion of membership for the European Parliament, but the constitutional structure for legislative action – Commission agenda-setting and legislative co-decision – remains unquestioned. With this structure for EU democratic federalism now firmly in place, what are the prospects for EU policymaking? Here the Union can learn important lessons from the recent U.S. budget and regulatory histories. Decentralized legislatures, unless checked by nationally (or, in the case of the Union, supranationally) elected executives with veto powers or stable national (or, for the Union, supranational) legislative political parties, will typically approve inefficient public budgets and government regulations. Decentralized legislative decision-making is inherently unstable, cycling from one majority, or qualified majority, coalition to another with no equilibrium policy guaranteed. If any policy decisions are to be made, further institutional structure beyond majority-rule will be required. These can be imposed from the outside, as in the case of a "take-or-leave-it" agenda-setting executive, or may arise from within the legislature itself, as in the case of legislative political parties with the ability to discipline members who fail to vote the party position.

Today's decision-making structure of the EU may be characterized as democratic federalism

U.S. congressional and state legislatures have discovered a third, and unfortunately very inefficient, way to avoid cycling in a "I'll-scratch-your-back-if-you'll-scratch-mine" norm of deference among legislators. Under this norm of voting, legislators informally agree to defer to others' favorite budget items or regulations if deference to their favorite choices is granted in return. The result is typically many very inefficient projects and regulations. Everyone consumes from the Union tax base paying only their very small share of costs but, when their project is "local," enjoying all the benefits. The best analog to this norm of budgeting is the behavior of a large group ordering lunch after agreeing to share the check. Since each person pays only a fraction of the cost of their own lunch, the incentive is to order too much food. To solve this "shared lunch" or "common pool" problem, either separate checks are required (subsidiarity and assignment) or someone needs to assume control over what people order (governance). There is strong evidence that "common pool" budgeting is pervasive in the decentralized legislatures of the United States (Gilligan and Matsusaka, 2001) and that the resulting budgets and regulations are economically inefficient (Inman and Fitts (1990) and Inman and Rubinfeld (1997b)).

Having adopted democratic federalism, the challenge for the Union is to now find a workable middle road between the indecisions of legislative

cycling and the inefficiencies of common pool budgeting. Again the U.S. experience is instructive. Occasionally we have solved our common pool problems with a strong elected executive with veto and agenda powers – Ronald Reagan comes to mind – or stable party control over legislative politics – for example, (southern) Democratic control of Congress from 1954 to1968.

It is unlikely the EU constitution will be revised to allow for the election of a single, institutionally powerful Union president. Thus supranational political parties within the Council of Ministers and the European Parliament will be needed. Within the Council, at least presently, this seems unlikely, too. There is, however, some recent evidence suggesting that Members of Parliament (MEP's) do vote along Parliamentary party lines, collecting around the positions preferred by the liberal Party of European Socialists (PES) and the center to conservative European People's Party (EPP). One must interpret such results with great care, however. Knowing that members vote with other Parliamentary party members may simply mean that members separately choose party labels and votes according to an exogenously specified ideological position, and not because the party is strong enough to control votes; see Krehbiel (1993). Careful empirical work by Kreppel (2002) and Hix (2002) establish very clearly that when local or national party interests are at stake, MEP's vote locally and not with their supranational EP parties. At the moment, EU legislatures lack strong party control of member voting behaviors. Inefficient common pool policymaking remains very much a risk for EU democratic federalism.

The EU's democratic federalism ensures rights protection and political participation, but not efficiency

There are two institutional hurdles within the current structure of EU federalism which may slow the tendency of Union legislatures to adopt inefficient public policies. The first is judicial enforcement of the principle of subsidiarity to deny inefficient Union projects and regulations. In our own research on U.S. federalism, we have outlined how the judiciary might apply the logic of subsidiarity to control U.S. legislative excesses; see Inman and Rubinfeld (1997b). Bermann (1994) has addressed this same question for the EU. Like us, he concludes that court enforcement should be limited to procedural matters only: When adopting policies, did the legislature weigh a possible violation of subsidiarity? A substantive evaluation of whether a policy does, or does not, meet the standards of subsidiarity seems to us, and to Bermann, well beyond the competency of the U.S. Supreme Court or the Union's Court of Justice. Judicial enforcement of procedural violations can be a check on policy inefficiencies, but it will be at best a low hurdle.

The Treaty of Nice offers a second moderating institution against policy inefficiencies. In an effort to placate the current large members of the Union, Nice increases the qualified majority necessary for policy passage in the Council; the resulting smaller "blocking percentage" strengthens the hand of the large members in Council decision-making. At the same time, in an effort to placate the many smaller members of the Union, Nice also requires any approved policy to win the support of an absolute majority of the nations in the Union. In an expanded 27 member Union, 14 small countries will be able to block legislation even when a qualified majority has approved a policy. These two changes together increase the ability of the Council to veto – that is, block – deviations from the policy status quo; see Tsebelis and Yataganas (2002). Thus really inefficient policies favored by Parliament can, *if* Council incentives are appropriate, be checked by the Council. To be effective, Council members must collectively favor Union-wide economic efficiency, however, and this very much remains an open question.

Today, the EU stands at a crossroad. For good reasons – rights protection and political participation – Union members have made a constitutional commitment to democratic federalism. Economic efficiency, however, remains in doubt. Admitting twelve new members in 2005, whatever the benefits for European political stability, will create added pressure for inefficient fiscal transfers, industry subsidies, and locally beneficial regulations. In light of the Union's current legislative performance, it seems unlikely that supranational political parties with a Union-wide electoral mandate will arise within the Council and Parliament to efficiently manage public policies.

The task then is to strengthen those EU institutions of assignment and governance that best promote efficiency. Articulating the principle of subsidiarity and requiring all policies to be measured against this standard, with the Court of Justice as the enforcer, is a good first step. A valuable second step has been the decision in the Treaty of Nice to strengthen institutionally the hand of the Council of Ministers over that of the European Parliament.

But when all this is said and done, the best safeguard against legislative inefficiencies will be, as it has been for U.S. federalism, an informed electorate willing to defeat all politicians and political parties that fail to find and embrace the efficient common ground.

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Subsidiarity and the Debate on the Future of Europe

Giovanni Grevi*

The background of the current debate

With the establishment of the Convention on the Future of Europe on 28 February 2002, the debate on the principle of subsidiarity for the functioning of the European Union, and on its application, entered a new phase.

The Laeken Declaration of December 2001[1] marked the beginning of a transition insofar as it reflected concerns expressed by political leaders over the previous months and set out the basic guidelines of the debate on the future of Europe. In this context, three priorities were indicated for further reflection:

- How to make the division of competences more transparent.
- How to determine whether there needs to be any reorganisation of competences.
- How to allow for flexibility in the distribution of competences.

The subsidiarity principle: Action should be taken as close as possible to the citizens

Interestingly, the need to *"ensure that a redefined division of competences does not lead to a creeping expansion of the competence of the Union or to encroachment upon the exclusive areas of competence of the Member States"* was stressed in the Declaration. This is a clear reflection of the warning signals sent by a number of leaders, particularly from the German regional establishment, in the run-up to Laeken. At the same time, the fundamental linkage between the question as to 'who does what' and *"the nature of the Union's action and what instruments it should use"* was established.

Prior to the Laeken Declaration, in December 2000, the Declaration on the Future of the Union adopted at Nice[2] put the question of *"how to establish and monitor a more precise delimitation of competencies between the European Union and the Member States, reflecting the principle of subsidiarity."*

Subsidiarity in context

In order to appreciate the main features of the ongoing debate and the distinctiveness of the political and institutional context of the Union, some preliminary remarks seem useful. To begin with, a short definition of subsidiarity is necessary to frame the guidelines of the discussion.

In short, subsidiarity is the principle whereby action should be taken as close as possible to the citizens, and left to private actors when the involvement of public structures is not required to achieve expected results. Higher levels of governments should intervene only when they can provide tangible added value in delivering policy outcomes. The essential trade-off at the core of the subsidiarity debate is between efficiency and freedom.

This definition needs, however, to be completed with two further observations. On the one hand, the principle of subsidiarity should be regarded not only as the criterion for the delimitation of competences between different public (or private) actors but also, and perhaps most importantly, as a dynamic principle governing the shift of these competences and guaranteeing the flexibility of the system. On the other hand, given the definition outlined above, it should be stressed that subsidiarity works both ways: from the top down, but also from the bottom up. This is particularly relevant when looking at the current debate at the European level, where the emphasis is

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[1] Presidency Conclusions, European Council Meeting in Laeken, 14–15 December 2001, SN 300/1/01.

[2] Official Journal of the European Communities C80, 10.3.2001, Declaration 23.

clearly put on the former dimension, and much less on the latter.

The principle of subsidiarity plays a fundamental role in establishing a workable relationship between different levels of government in any multi-level framework. While, however, the principle normally applies to decision-making in federal states, this is of course not the case when looking at the European multi-level framework.

The components of the European Union – Member States – are far more heterogeneous than the components of any other federation in the world, with the possible exception of India. Their number is rapidly growing with successive waves of enlargement, and the diversity of interests to be included in decision-making at EU level is expanding exponentially.

Most of these component units are, in turn, divided into a number of sub-units – regions, Länder, comunidades autonomas etc. – with very different degrees of autonomy. In fact, some of these 'sub-national' entities are endowed with law-making powers and have elected governments. The so-called 'constitutional regions' are effectively fully-fledged state-like systems.

Most notably, political or administrative subdivisions in the Member States of the European Union correspond to deep-rooted distinctive historical traditions, such as in the case of Germany, or to national differences *tout court*, as in the case of Belgium, Spain and the United Kingdom. In fact, a considerable number of the calls for more powers being allocated at the national level actually originates from the concern of regional entities to preserve their own competences in areas such as education or health. These policy areas reflect the distinctive character of a socio-economic model, and sub-national entities are reluctant to entrust Member States' governments with legislation at EU level in the Council of Ministers.

In stark contrast to most federal constitutional systems, the power to allocate competences to the European level of government – or *Kompetenz-Kompetenz* – firmly belongs to Member States. This is reflected in the so-called principle of attribution of powers, enshrined in Article 5 TEC. It implies that all EU powers are not sovereign but derived. Also, the role reserved to the Union in those areas where normally federal competence is exclusive, is actually quite limited. This is the case as far as internal and external security policies are concerned, but also for foreign policy more widely. Of course, monetary policy is managed at the federal level for those countries belonging to the euro zone.

This leads to a further important consideration, namely that one very distinctive expression of the principle of subsidiarity in the context of the European Union is differentiated integration. Arguably, the mechanism whereby a group of EU Member States can undertake 'enhanced cooperation' in a given policy area, such as, for example, armament procurement, reflects the need to allocate the exercise of competences in this field to a different level of government, better equipped to act effectively. From this standpoint, therefore, moves towards differentiated integration in the Union (whether by way of 'variable geometry' or by shaping a 'two speed' Europe) basically result in allocating competences to intermediate levels of government between the Member States and the fully-fledged EU level.

Besides subsidiarity there are three other important principles: transparency, proportionality and union loyalty

Subsidiarity in the Treaties

Turning to the primary law of the European Community and of the European Union, the principle of subsidiarity cannot be considered in isolation from at least three other important principles informing the functioning of the EU: transparency, proportionality and Union loyalty.

According to Article 1 TEU, decisions in the Union *"are taken as openly as possible and as closely as possible to the citizen."* Two points deserve particular attention in this respect.

Firstly, transparency and subsidiarity are indicated as the two sides of the same coin. This is relevant because one of the most pressing demands in the current debate is that responsibilities are clearly allocated so that citizens can understand 'who is responsible for what'. However, some confusion seems to occur between the very legitimate call for transparent decision-making, and the instrumental use of subsidiarity to justify a rigid delimitation of competences.

Secondly, a direct reference is made to the citizens: this seems to pave the way for an application of subsidiairty in the functioning of the Union that

goes beyond the two-level game involving the EU and Member States, and extends to sub-national entities. So far, there has been considerable resistance to opening the discussion on the delimitation of competences to the sub-national level, but interesting developments are taking place in the current debate at the Convention as to the monitoring of subsidiarity, as reported below.

Article 5 TEC states that: *"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 insofar 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."*

Subsidiarity does not imply a rigid delimitation of competences

This provision reflects a more legalistic approach to the application of the principle of subsidiarity. Notably, its application is limited to areas that do not fall within the remit of the exclusive competence of the Union, and parameters for action are set down. Interestingly, the reference to 'exclusive' competences, whether of the Union or of Member States, is increasingly challenged as a reliable, and workable, criterion for delimitation.

The procedural steps to be taken for ensuring that the subsidiarity dimension is fully acknowledged in the decision-making process are specified in detail in the Protocol on the Application of the Principle of Subsidiarity and Proportionality, attached to the Treaty of Amsterdam. From this standpoint, the main innovation in the Convention is the consensus on the involvement of national parliaments in the monitoring of the application of subsidiairty.

As to the principle of proportionality whereby, according to Article 5 TEC, *"Any action by the Community shall not go beyond what is necessary to achieve the objectives of this Treaty"*, this is arguably the real target of much questioning of EU intervention. It is somewhat misleading to challenge the competence of the Union to legislate in a given policy field, when the actual problem is the degree of detail of legislation. This is a key point in the debate, and is central to the question of 'Complementary competences', recently the subject of a report of one of the Working Groups of the Convention.

Article 10 TEC expresses the principle of Union loyalty or solidarity, by establishing that *"Member States shall take all appropriate measures…to ensure the fulfilment of the obligations arising out of this Treaty or resulting from action taken by the institutions of the Community. They shall facilitate the achievement of Community's tasks. They shall abstain from any measure which could jeopardise the attainment of the objectives of this Treaty."*

It should be noted that the inclusion of a clause of reciprocity, whereby the Union shall respect the responsibilities and identities of Member States, is likely to be the outcome of the ongoing debate in the Convention on this particular subject. This would go beyond the present wording of Article 6.3 TEU, whereby *"The Union shall respect the national identities of its Member States."*[3]

Three highways in the Convention

The debate on the principle of subsidiarity and its implications taking shape in the Convention is essentially threefold, focusing in particular on: the question of the delimitation of competences; the link between competences and instruments; and how to effectively monitor the respect of subsidiarity.

The delimitation of competences

This important issue is central to the ongoing political controversy on the distribution of power between the Union and Member States, but it should be made clear that delimitation does not necessarily result from a correct application of the principle of subsidiarity. Contrary to what might appear, the two questions are separate. As indicat-

[3] The Final Report of the Working Group 'Complementary Competences', CONV 375/02, 31 October 2002, recommends that *"TEU Article 6(3) should be made more transparent by clarifying that the essential elements of national identity include fundamental structures and essential functions of the Member States notably their political and constitutional structure, including regional and self-government; their choices regarding language; national citizenship; territory; legal status of churches and religious societies; national defence and organisation of armed forces."* The full text of the report is available at http://register.consilium.eu.int/pdf/en/02/cv00/00375-r1en2.pdf. Most interestingly, the very recent 'Feasibility Study' published by the Commission on 4 December and consisting of a fully fledged constitutional text for the Union, already includes a clause of reciprocity in Article 4 of Part I – Principles: *"In compliance with the subsidiairty principle, the Union shall act in good faith in relation to the Member States and shall preserve their identity and their national and regional diversity. It shall respect the constitutional organisation of the Member States, including in its relations with territorial units. The Union shall be mindful of the specific features of Member States as regards their internal and external security and their public services."* The text of this Working Document of the Commission is published at http://europa.eu.int/futurum/documents/offtext/const051202_en.pdf.

ed above, subsidiarity does not imply a rigid delimitation of competences: it simply establishes that the most appropriate level of government shall take action, with a view to reconciling autonomy and efficiency. From a procedural standpoint, in the presence of appropriate mechanisms for ensuring the participation of all interested parties in decision-making, no division of competences would be required at all. If this is an extreme solution in the direction of flexibility, it should be stressed that establishing watertight catalogues of competences would go too far the other way.

The divergence between these two extreme solutions and their supporters is essentially a difference of *Weltanschauung* as to what the Union is about. If one believes in a progress towards an *"ever closer Union"*, then a 'functional' approach to the allocation of competences would seem the most appropriate. The Union would be given objectives, and would be able to adopt necessary measures to fulfil them, while respecting subsidiarity.[4] On the other hand, if one sees clear limits to EU integration, then competences and instruments should be very clearly identified, and the Union should be able to take action only where a precise legal basis exists.[5] *As usual, in medio stat virtus.*

Given the growing heterogeneity of the Union and the consequent increasing need to ensure consistency, it is arguable that an excessive delimitation of competences would be inappropriate. The vast majority of competences are in fact shared, and this is true both for those primarily exercised by the Union, and for those where Member States are mainly responsible.

This was the position taken by most members of the Convention at the plenary sessions in April and May[6] However, recent developments seem to indicate the political will to establish a clear demarcation between different categories of competences, namely defining three levels: exclusive EU competences, shared and complementary competences. The elaboration of the last category was the subject of extensive reflection in the Convention Working Group chaired by Henning Christophersen.[7] The recommendations of this WG, presented at the plenary session on 8 November, triggered a very lively debate and met more opposition than support.

Aside from the general criticism of the idea of delimitation of competences as such, two main problems arose in this context:

- The proposed change of name, from 'complementary competences' to 'supporting measures', marks the shift from a sphere of action to a type of instrument. A large majority of the members of the Convention felt that this was inappropriate and confusing. It was also argued that, from a legal standpoint, what distinguishes complementary competences from shared ones is simply that the exercise of the former does not pre-empt the right of Member States to legislate in future.
- The exclusion of EU legislation from the policy areas listed in this context – namely employment, education and vocational training, culture, public health, trans-European networks, industry, research and development – led to much disappointment. It was argued that the real issue is the 'intensity' of EU intervention – therefore a matter of proportionality and not of subsidiarity. Some suggested that sufficient protection of Member States' competences would be guaranteed by excluding harmonisation of national provisions by EU law.

There are three levels of competences: exclusive EU, shared, and complementary

The Preliminary Draft Constitutional Treaty issued by the Praesidium of the Convention on 28 October 2002 envisages a delimitation of competences in three different categories (Article 9 to 12, Part One), and includes the exclusion of EU legislation in *"the areas in which the Union supports and coordinates action by the Member States."*[8]

The 'Feasibility Study' published by the Commission on 4 December[9] – a fully-fledged constitution-

[4] For a position closely reflecting this approach, see the contribution submitted by the Belgian members of the Convention, CONV/53/O2, 1" May 2002: "*The Union's powers, which are functional in nature, are simply means whereby it carries out its missions and achieves its objectives … powers will be defined on the basis of missions and objectives.*"

[5] This alternative model is clearly outlined in the Bundesrat Resolution on the division of competences 1081/01, 20 December 2001, whereby "*the principle of limited specific authorisation to act must be reinforced*" and "*differentiated indication of the admissible legal instruments and the ways in which the Community may pursue its objectives should be given if specific authorisations to act are granted.*"

[6] The summaries of all the plenary sessions of the Convention are available at http://european-convention.eu.int/sessplen.asp?lang=EN

[7] The full set of Working Documents produced by this Working Group can be found at http://european-convention.eu.int/dynadoc.asp?lang=EN&Content=WGV. For the text of the Final Report, see above n. 3.

[8] The text of the Preliminary Draft Constitutional Treaty is available at http://european-convention.eu.int/docs/sessPlen/00369.en2.PDF.

[9] See n. 3 above.

al text for the Union – outlines an alternative model whereby policies are divided in the first part of the text into principal policies of the Union, flanking policies and complementary action. This is a sort of political statement, helpful for citizens to understand the remit of the European Union and of Member States in clear and simple terms. Part Three of the document, dedicated to the description of individual policy areas, sets out a more detailed break-down of the powers of the Union and of the instruments available to it, reflecting the notion of different degrees of 'intensity' of EU action. It should also be noted that the rules envisaged for the amendment of the detailed provisions of Part Three – Policies – are less demanding than the procedures established for the revision of part One – Principles.

The link between competences and instruments

Instruments are needed to implement the competences

The attempt at linking competences to instruments is a very relevant aspect of the debate. As stated in one of the notes prepared by the Secretariat of the Convention as a basis for debate, *"The subject of legal instruments follows on logically from that of competences: once it has been decided to implement a competence, it is necessary to decide who can do it, how, and with what effects."*[10]

A shift in focus away from the actor responsible for taking a decision to the most appropriate instrument for implementing that decision – that is, from subsidiarity to proportionality – should be welcomed. Addressing the two questions simultaneously shows the close linkage between the two principles. On the other hand, it is arguable that a rigid link between a certain type of competence and a specific instrument would excessively narrow the margins of EU action.

The concept of 'intensity' is pivotal here. A number of contributions have been submitted listing the various 'modes' of EU intervention. The German Bundesrat, for example, indicated five categories in its contribution to the Convention: harmonisation, mutual recognition, financial support, supplementary measures and coordination.[11] As a result of the key intervention by Paolo Ponzano of the European Commission[12], the WG on Complementary Competences came out in favour of a more elaborated scale of EU intervention, with a distinction between legislative and non-legislative action and related examples, in its final report. Whether such *"hierarchy of intensity"* is to be enshrined in the future EU constitution or not is a matter for discussion. However, it is surely the intellectual backdrop of the hierarchy of instruments recommended in the final report of the WG on Simplification chaired by Giuliano Amato.[13]

The debate in this WG was inspired primarily by the need for simplification. It was felt that simplification was a prerequisite for enhancing the democratic legitimacy of the Union. At the same time, however, the definition of a limited number of instruments (and procedures) and the clear identification of their effects meets the expectations of those who denounce the obscure character of the system, and the scope for prevarication that it entails. Three levels are identified for the adoption of acts by the Union: legislation, delegation and implementation. Legislative acts include laws, framework laws and decisions. Delegated acts are a new type of instrument whose scope is determined by the legislative act. They *"supplement or develop the detail of a legislative act or adapt certain elements of the actual legislative act, always under the powers defined by the act"* and they are adopted in the form of delegated regulations. Finally, implementing acts, which fall in principle within the responsibility of Member States, are to be adopted by the Commission through the system of comitology. They consist of implementing regulations or implementing decisions.

A smaller number of instruments and a new, simpler language should ensure that citizens are in a position to better understand what is being decided at the European level, all the more so given the parallel simplification of decision-making procedures and the widely expected opening to the public of the legislative proceedings in the Council of Ministers. Arguably, there will be fewer complaints against the 'Brussels machinery' and more pressure on national governments and national parliaments.

[10] CONV 162/02, 13 June 2002, available at http://register.consilium.eu.int/pdf/en/02/cv00/00162en2.pdf
[11] See n. 5 above.
[12] Among the many key contributions by the Commission to this WG, see 'Delimitation of powers: a matter of scale of intervention', WD 4, 10 July 2002, available at http://european-convention.eu.int/docs/wd5/1722.pdf
[13] The Final Report, CONV 424/02, 29 November 2002, can be found at http://register.consilium.eu.int/pdf/en/02/cv00/00424en2.pdf

As noted above, a different matter is whether a clearer definition of the instruments should lead to a detailed association of types of instruments with the different competences of the Union. According to the German Bundesrat, *"differentiated indication of the admissible legal instruments and the ways in which the Community may pursue its objectives should be given if specific authorisations to act are granted."* Others believe that the most appropriate instruments should be decided on a case-by-case basis.

The former approach might lead to an extremely complex, and probably very rigid system. That would not be in line with some of the priorities emerging in the Convention debate as to the features of the new institutional framework. For example, if one takes a look at defence policy, currently discussed in one of the Convention WGs, it would not make much sense to define one – presumably non-legislative – instrument of EU intervention. On the contrary, at least three areas of action could be considered: purely military matters (intergovernmental instruments and procedures); crisis management (mixed instruments and procedures); armament procurement and R&D (legislative instruments and community method).

A potential compromise might consist in indicating in the legal bases of the future constitution, not the instruments but the 'modes' of action, or in excluding some of them, such as harmonisation.

Monitoring subsidiarity

Before discussing how best to monitor the application of subsidiarity, one first needs to determine whether subsidiarity is a principle of political or legal nature. While it seems hard to draw a clear distinction between these two aspects, some members of the Convention feel that judicial scrutiny of subsidiarity would be more appropriate to avoid political controversy. Decisions by the European Court of Justice (ECJ) would be clear and motivated, and its legal authority would not be challenged.[14] Others, however, take the view that the ECJ would run the risk of undue 'politicisation', were it to be involved in reviewing an essentially political choice. This was the line taken by some of the experts who contributed to the proceedings of the WG dedicated to the monitoring of subsidiarity, chaired by Inigo Mendez de Vigo.[15]

According to the conclusions produced by the WG, subsidiarity is a principle of *"essentially political nature" and "monitoring of compliance with that principle should be of an essentially political nature and take place before the entry into force of the act in question."* On the basis of that assumption, the WG sought to avoid complicating decision-making and shaped a mechanism for preliminary political control on the part of national parliaments, failing which the option would be open for recourse to the Court.

The approach includes three steps:

- Firstly, national parliaments must be more closely associated throughout the whole of the legislative process. In particular, the Commission should address its legislative proposals to each national parliament at the same time as to the Council and the European Parliament. The same is envisaged for the 'common position' to be discussed by the Conciliation Committee in the context of the co-decision procedure.
- Secondly, an *ex ante* political mechanism or "early warning system" should be established for identifying infringements of the subsidiarity principle. Within six weeks from the date on which a proposal is sent, each national parliament would have the right to issue a *"reasoned opinion"* concerning compliance with the principle of subsidiarity. Depending on the number of opinions submitted, the Commission could be obliged to re-examine its proposal.
- Thirdly, national parliaments should have access to an *ex post* judicial review by the ECJ. With a view to limiting the scope of this access, the decision was taken to link the right of appeal to the Court to the presentation of a reasoned opinion *ex ante*. However, this could result in an artificial incentive to submit opinions in advance with the sole purpose of preserving the right of recourse to the Court. Finally, it should be stressed that indi-

Since subsidiarity is a political principle, monitoring should also be of a political nature

14 See in this sense the contribution 'Subsidiarity must be controlled by a judicial body', CONV 213/02, 24 July 2002, by Elmar Brok MEP and Jacques Santer MEP among others.

15 The Working Documents produced by this WG are available at http://europeanconvention.eu.int/dynadoc.asp?lang=EN&Content=WGI. The text of the Final Report, CONV 286/02, is available at http://register.consilium.eu.int/pdf/en/02/cv00/00286en2.pdf. As to the debate above, see more specifically the contribution by Jean-Claude Piris, Director general of the Legal Service of the Council of Ministers, WD 4, at http://european-convention.eu.int/docs/wd1/1347.pdf, and the oral contribution by Francis Jacobs, Advocate General at the ECJ, to the meeting of the WG on 25 June 2002.

vidual chambers of bicameral assemblies are entitled to appeal to the Court. That might lead to interesting developments under domestic politics in those federal systems where the 'second chamber' of the regions (such as the Bundesrat) is often of a different political colour from the national government.

The idea has also been advanced that the Committee of the Regions should be allowed to appeal to the Court in relation to "*proposals which have been submitted to the Committee of the Regions for an opinion and about which, in that opinion, it had expressed objections as regards compliance with subsidiarity.*" This is an important development towards opening policy-making at the European level to sub-national actors and to the interests of regions, albeit through the filter of a consultative body of the Union.

Implications of subsidiarity for an enlarged Union: No rigid delimitation of competences

The final report of the WG includes significant references to the question of better distribution of competences and to the simplification of the legislative instruments available to the Union, and the clarification of their effects. These two strands of reform, considered above, are considered prerequisites for the proper application and monitoring of the principle of subsidiarity.

Conclusion

Following this short overview of the debate on the principle of subsidiarity and its implications for the functioning of the enlarged Union after 2004, some political guidelines can be drawn for further reflection.

Broadly speaking, it would be a mistake to insist on a rigid delimitation of competences between different levels of government within the Union. European integration is a necessary condition for achieving high standards of security and prosperity for European citizens. Following enlargement, it is arguable that the principle of solidarity will be at least as relevant to EU strategic decisions as the principles of subsidiarity and proportionality. Moreover, European integration is not an end in itself, but a step towards a better model of global governance. All things considered, any move towards stifling EU decision-making by imposing severe constraints would be a step backwards. More and not less flexibility will be required from now on.

The argument whereby European citizens want a clear allocation of competences to be able to hold to account those responsible for important decisions is a valid one. However, this is only a partial solution to a wider problem, namely the obscurity and complexity of European decision-making. Opening up the proceedings of the Council of Ministers when it legislates, as well as simplifying instruments and procedures, represents a key step forward in enabling citizens to understand and judge decisions taken at the European level. With this in mind, the idea of a somewhat artificial, detailed distinction between different levels of powers is neither necessary nor desirable.

The principle of proportionality, whereby the 'intensity' of European intervention should not go beyond what is necessary to achieve expected results is now firmly anchored in EU decision-making. As a consequence, framework legislation is to be preferred wherever possible. That leaves more room for Member States' discretion in implementation, as the Union does not have the resources to supervise the crucial phase of implementation.

The implementation of subsidiarity should be looked at in this context, and not simply as the question of who legislates. Decisions are shaped *ex ante* though extensive consultation (this is the direction taken by the European Commission with its White Paper on European Governance), and require *ex post* a joint effort involving various actors at different levels to ensure proper implementation. This does not imply that clear limits should not be set to the undue expansion of Union intervention in the area of Member States' competences. However, the effective cooperation between all the relevant actors is a much more faithful application of the principle of subsidiarity than a regressive, and outdated, separation of competences.

Should the EU have a President with two hats?

Yes

Ben Crum*

A debate has recently started about the future of the presidency of the European Union. In turn, the prime ministers of France, the UK, Spain, Italy and Sweden have argued that the current system of the rotating presidency should be replaced by a full-time president. Clearly the rotating presidency is running out of steam. As if governing one's own country is not enough, the presiding government is expected to fulfil ever more duties. Some governments are better able to handle the presidency than others. Moreover, after enlargement, each member state will only come to hold the presidency once every 12 or more years.

While the proposal for a full-time president will remove the problems of the rotating presidency, it will create others as it institutionalises a second system of executive power in Brussels. So far the European Commission has been the most permanent embodiment of the Union, but its executive powers are limited in important respects. Most strikingly, executive power in key policies, such as foreign policy and security, has been kept under the firm control of the Council and its own secretariat.

With a full-time president, the Council secretariat is likely to develop into a parallel administration. This will create serious coordination problems, if not outright conflict, between the two administrations. More fundamentally, the presence of two administrations is bound to further reduce the credibility of the Union in the eyes of the public.

To prevent this situation, the obvious solution is to fuse the two administrations and to have this fusion embodied by the Union President with 'a double hat': chairing the European Council as well as the College of Commissioners. The advantages of this reform are manifold. First of all, it would restore a relationship of trust between the Council and the Commission. It would clarify the administrative organisation of the Union, as well as facilitate the integration and simplification of executive procedures. It would also preclude the development of the Council secretariat into a second European administration and optimise the use of Union resources.

This radical proposal is bound to provoke a number of objections. For a start, one may wonder whether an EU President with two hats would not distort the precious institutional balance of the Union. However, this risk can be avoided by subjecting the President's powers to checks and balances, some of which can already be discerned in the present system. The European Treaties provide a stringent delineation of the Union's powers. Further, the President's powers would be bound by the European legislator consisting of the Council and the European Parliament. Following Montesquieu, the key here is to ensure that the institutions remain politically separate and that none of them will ever be able to control the decisions taken by the other.

Would not an EU President distort the role of the Commissioner as the impartial guardian of the European interest? The classical image of the Commission as a technocratic, impartial broker has long been superseded by actual practice. As the Commission has assumed ever more tasks, it has also been obliged to take a political stance, but this does not necessary imply that it has to relinquish its role as guardian of the general European interest. Moreover, to prevent the Commission from developing into a party-political body, its other members should still be nominated by the member states (in collaboration with the President).

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Can an EU President be held democratically accountable? Supposedly the EU President would be a former head of state who has substantial experience in the European Council and can wield the necessary authority inside and outside the Union. Thus, naturally, the European Council should be able to control the selection procedure. At the same time, if the EU President will be at the head of the Union's executive powers, the nominee would also need the support of a majority of the European Parliament. Similar to the right of approval it currently enjoys on the Commission President, the Parliament should have a decisive word on the Union President.

Thus, while the European Council would indicate whom of its former members it would be willing to accept as its President, the European party groups could turn the choice of the President into a central issue in the EP elections. Imagine the electoral impact if in the next EP elections the two major party groups in the European Parliament, the Christian-Democrats and the Social Democrats, were to adopt José Maria Aznar and Tony Blair as their candidates for the EU Presidency. Indeed, a President presiding over an integrated European executive and accountable to both the European Council and the European Parliament may be the key to providing Europe with a credible democratic face.

No

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When the presidium presented a "skeleton for a Constitutional Treaty", this structure on purpose did not contain concrete proposals for changes in the EU institutional architecture. There is a place holder for the "Presidency of the EU", however. Although institutional questions will not be discussed in the plenary until the beginning of next year, the opinion of the different components in the Convention is being formed now and the players have started to voice their opinions.

The institutional setup is, of course, a question of power. The main battle line is between those who want more power for the Commission and Parliament and those who want to rely more on the nation states and thus on the Council. We are only at the start of this debate now. Transferring the idea of a "double hat" figure also to the Presidency of the EU is interesting and could be helpful in search of a compromise at a later stage of the Convention. However, before settling for less by agreeing on the seemingly "easy" approach of dissolving the antagonisms by merging the functions, we should first seriously try to find solutions that see all institutions on their own merits. Democracy is all about checks and balances, and antagonisms are built-in stabilisers.

The challenge is therefore to find the right balance among the institutions. The relationship is delicate, an increase in power for one institution will also affect the others. An isolated approach focussing on just one element would be counterproductive. In my opinion, the reforms should aim at a strenghtening of all parts of the institutional triangle at the same time.

Several proposals are floating around. There is, on the one hand, the idea of a high profile President of the EU selected by the Council, the so called ABC proposal. Mr Blair has reiterated this proposal in his speech in Cardiff lately. The idea of a "Super President" of the Union has been met with suspicion by the smaller member states. They are concerned about being dominated by a "directorium" of the large countries. Looking back at Nice, their concerns have to be taken seriously. Several days ago, Guy Verhofstadt, the Belgian Prime Minister, at the College of Europe in Bruges, opposed the idea of electing a President of the European Council from outside the membership of this body and for a longer period. Luxembourg shares this view.

The European Parliament, along with the Commission, is also not in favour of an executive Council President. It would weaken the democratic control function, as the President and his budget could not be controlled by the European Parliament. He could not be dismissed either. This model would thus lead to a weakening of the European Parliament and democratic accountability. Establishing a President with executive functions would also lead to a loss of efficiency by creating two administrations spending a lot of their time competing each other.

On the other hand, a strengthened role for the President of the European Commission is suggested, a proposal with which a number of small countries can associate themselves. The overall goal is to enhance the executive role of the European Commission and at the same time its democratic control by the European Parliament.

Ideally, the President of the Commission should be elected by an absolute majority of the European Parliament. The European Council would then

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approve his appointment. The ongoing debate has shown that this may be premature, however.

Therefore a compromise could take into account the interests of member states anxious to lose influence. A candidate for President of the European Commission should be proposed to the European Parliament by the European Council by qualified majority vote. New in this proposal is that the European Council should select the candidate in light of the outcome of the European elections. This would strengthen the democratic control function and increase the political weight of the European Commission. It would result in a presentation by the political parties of presidential candidates in the European elections. This more personalised electoral campaign would be more attractive to the voters, raising their interest in European politics.

Does Sales-only Apportionment of Corporate Income Violate International Trade Rules?

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In 1978, the year the U.S. Supreme Court sustained the constitutionality of Iowa's single-factor apportionment formula based on sales (at destination) of tangible personal property[1], almost all the states that imposed corporate income taxes placed equal weight on property, payroll, and sales. Now almost three-fourth of the states that have corporate income taxes place at least half the weight on sales, and eight base apportionment solely on sales.[2] It seems reasonable to believe that this trend will continue and that other states will adopt sales-only apportionment formulas in an effort to improve their competitive positions.[3] This note, which is intended to stimulate further analysis and debate, rather than provide a definitive conclusion, suggests that sales-only apportionment may violate international trade rules that prohibit export subsidies.[4] Given this purpose, we concentrate on the simplest case, involving the apportionment of income from the manufacture and sale of tangible personal property, where there appears to be a prima facie violation of international trade rules, inviting others to consider other more complex situations. Perhaps we should note at the outset that we are not arguing that international trade rules make sense; rather, we take them as given.

The international trade rules prohibiting export subsidies

Under international trade rules adopted during the Uruguay Round of multilateral trade negotiations in 1994, the world trade community reaffirmed and reinforced the long-standing prohibition against export subsidies embodied in preexisting trade rules and related understandings.[5] Specifically, the Uruguay Round Agreement on Subsidies and Countervailing Measures (SCM Agreement) defined a "prohibited subsidy" to include "subsidies contingent, in law or in fact, whether solely or as one of several other conditions, upon export performance."[6] Prior to the adoption of the Uruguay Round Agreements, the General Agreement on Tariffs and Trade of 1947 (GATT 1947),

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[1] Moorman Mfg. v. Bair, 437 U.S. 267 (1978). This note concerns only the apportionment of income from the manufacture and sale of tangible personal property. Although some states assign sales from services on a market state or destination basis, most states assign sales from services on the basis of where the income-producing activity relating to those sales is performed. See Uniform Division of Income for Tax Purposes Act [UDITPA] § 17(a). Accordingly, single-factor apportionment of such sales often does not raise the issues addressed in this note, which concerns the exclusive use of a destination-based sales factor to assign income. Moreover, the original 1947 General Agreement on Tariffs and Trade (GATT 1947), discussed further below, applied only to goods. When the United States adopted the Uruguay Round Agreements, thereby extending the scope of international trade rules embodied in GATT 1947 to services under the General Agreement on Trade in Services (GATS), it explicitly reserved from the scope of the GATS national treatment requirement:

> Sub-federal tax measures which afford less favorable treatment to services or service suppliers of another Member based on the method of allocating or apportioning the income, profit, gain, losses, deductions, credits, assets or tax base of such service suppliers or the proceeds of a services transaction.

These reservations were submitted to the GATT on June 29, 1994 as a "Schedule of Specific Commitments for the U.S" in connection with its adoption of the Uruguay Round Agreements. The reservation quoted above was designated as "paragraph 3."

[2] See Mazerov (2001). Connecticut, Massachusetts, and Missouri are included in this count, since sales-only apportionment is available to manufacturers in the first two states and is an option in the third.

[3] Indeed, the California Assembly's Revenue and Taxation Committee has approved a measure that would change the state's current three-factor formula with double weight on sales to a single-factor formula based exclusively on sales, Pratt (2002a), and both incumbent Governor George Pataki of New York and one of his Democratic rivals (Andrew Cuomo) have supported New York's adoption of a single-factor sales formula. Plattner (2002). The California measure is currently on hold due to its revenue implications. Pratt (2002b).

[4] This is, of course, not all that is wrong with sales-only apportionment; see Hellerstein & Hellerstein (1998), at pp. 8-233 to 8-234; Hellerstein (1995); Mazerov (2001) and McLure (forthcoming). It appears at first glance that sales-only apportionment may also constitute a tax on imports that is prohibited by international trade rules. We do not discuss that possibility in detail, although we advert to it briefly in the notes below (see infra ns. 21&22), as there may be reasons why it would not actually have the effect of taxing imports, such as lack of nexus and the use of domestic affiliates of foreign corporations to make imports in states without single-factor sales formulas.

[5] In April 1994, after years of discussion, more than 100 participating countries signed agreements reached in the Uruguay Round of multilateral trade negotiations. The Uruguay Round negotiations were conducted under the auspices of the original 1947 GATT. The results of the Uruguay Round consist of the Agreement Establishing the World Trade Organization (WTO) plus 16 multilateral and two plurilateral agreements (including GATT 1947), which are annexed to the WTO Agreement, as well as many other annexes, decisions, and understandings referenced in the principal agreements. See generally Hellerstein (1995).

[6] Agreement on Subsidies and Countervailing Measures, Article 3.1(a).

which is now incorporated in the Uruguay Round Agreements[7], imposed general restraints on "any subsidy … which operates directly or indirectly to increase exports ."[8]

For many years, GATT's prohibition of export subsidies has been understood to prohibit so-called "border tax adjustments" (BTAs) for direct taxes, such as income taxes and payroll taxes, while permitting BTAs for indirect taxes, such as value-added taxes, sales taxes, and excise taxes.[9] Although the term BTA does not appear in GATT 1947, in 1970 a Working Group of the GATT described BTAs generically

> *as any fiscal measures which put into effect, in whole or in part, the destination principle* (i.e. which enable exported products to be relieved of some or all of the tax charged in the exporting country in respect of similar domestic products sold to consumers on the home market and which enable imported products sold to consumers to be charged with some or all of the tax charged in the importing country in respect of similar domestic products) (emphasis added).[10]

Sales-only apportionment appears to violate the international trade rules prohibition against providing export BTAs for direct taxes (hereafter simply "export subsidies").

The economics of formula apportionment[11]

The Need for Formula Apportionment

The American states have long recognized – and the Member States of the European Union are coming to realize – that geographically separate accounting is not practicable within a highly integrated economy such as the United States. First, economic interdependence within or between controlled corporations often makes it impossible to isolate the geographic source of profits on a separate accounting basis. Second, even if corporations undertook to account separately for the income earned in each state, the task would be fearfully expensive, because their books and records would need to be maintained to reflect the details of their business operations on a state-by-state basis. Third, separate accounting is vulnerable to the manipulation of actual or imputed transfer prices within the enterprise in a manner that shifts income to low-tax states. As a result, the states, like the provinces of Canada, have long employed formula apportionment to determine the portion of the income of multistate corporations they will tax.

Some states apportion the combined income of related corporations deemed to be engaged in a unitary business, rather than limiting apportionment to the income of separate legal entities. In the late 1980s, following a period in which some states combined the worldwide activities of commonly controlled corporations, the states, under political pressure from the federal government, foreign governments, and the business community, imposed "water's edge" restrictions on combined reporting.[12] A more detailed analysis of the basic question addressed in this note would take account of combination and other variations of state practice.

UDITPA and the multistate tax compact

During the first half of the twentieth century the states used a wide variety of divergent apportionment formulas, before converging toward the standard practice of employing three equally weighted factors of property, payroll, and sales in the formula used to apportion income. Throughout this period the quest was to find a formula that would accurately reflect the geographic source of income, tempered by the need to provide for a formula that

[7] See supra note 5 and infra note 8.
[8] GATT 1947, Article XVI. The General Agreement on Tariffs and Trade 1994 (GATT 1994) consists of (1) GATT 1947 "as rectified, amended or modified" by the various legal instruments that enterd into force before the date of the WTO Agreeement; (2) provisions of legal instruments entered into force under GATT 1947 before the date of the WTO Agreement, including, among other things, "decisions of the CONTRACTING PARTIES to GATT 1947"; and (3) agreements reached during the Uruguay Round. GATT 1994, Paragaphs 1(a) -1(d).
[9] Hufbauer (2002a); Hufbauer (2002b). The prohibition of BTAs for direct taxes was originally implied by silence, but was made explicit in the Illustrative List of Export Subsidies contained in the Code on Subsidies and Countervailing Measures adopted in 1979 at the Tokyo Round and repeated in Annex I to the Uruguay Round Agreement on Subsidies and Countervailing Measures.
[10] The GATT Working Group on border tax adjustments, in its report of December 2, 1970, attributes this description to the OECD; see http://www.worldtradelaw.net/reports/gattpanels/bordertax.pdf, visited May 2, 2002. For a much more complete discussion, see Hufbauer and Erb (1984).
[11] For a more detailed exposition of the points covered in parts A and B of this section, see Hellerstein and Hellerstein (1998), Chapter 8.
[12] With the limited exception of oil companies in Alaska, all the states now limit mandatory combination to the "water's edge." That is, with limited exceptions for certain tax haven and other corporations whose activities are conducted predominantly in the United States, only domestic corporations are included in the combined groups and only the income of such corporations is apportioned. In some states, notably California, there is a water's-edge election; taxpayers that fail to make the election are subject to worldwide combined reporting.

fairly divided income among the states.[13] The broad consensus that emerged in favor of the equally-weighted, three-factor formula as a reasonable method for attributing income to the states embodied both traditional "sourcing" concepts in the weight accorded to capital (property) and labor (payroll) and the equitable claim of the "market" state to a share of the income tax base, as reflected in sales made into the state.[14] In 1957 the National Conference of Commissioners on Uniform State Laws (NCCUSL) approved the Uniform Division of Income for Tax Purposes Act (UDITPA), a model law intended to provide the basis for uniform state taxation of corporate income. UDITPA, which was incorporated in the Multistate Tax Compact, codified the then standard equally weighted three-factor formula.[15] While 20 states are currently members of the Compact,[16] most have forsaken its underlying purpose to "[p]romote uniformity"[17] by abandoning the uniform apportionment formula and placing greater weight on the sales factor.[18]

The economic effect of sales-only apportionment

It is easy to understand why states have reduced the weight on property and payroll in their apportionment formulas and have increased the weight on sales. Formula apportionment has the economic effect of converting a tax on corporate income into a set of taxes on the factors in the apportionment formula[19] That is, the sales-related portion of the income tax is roughly equivalent to a destination-based sales tax[20], the payroll-related portion is equivalent to a tax on payroll, and the property-related portion is equivalent to a tax on property. Since both payroll and property are origin-based factors and sales is a destination-based factor, the shift in weights that is occurring reduces the weight on the *origin* of interstate sales used to assign income and increases the weight on the *destination* of such sales, thereby increasing the state's competitive position in both in-state markets and out-of state markets, including foreign markets. To see this in the case of foreign exports, consider the simple case of a corporate manufacturer, all of whose payroll and property are located in a single state, that either exports all of its output or sells all of it in the state where it is produced.

Exports. Under the equally weighted three-factor formula, if the corporation exported all its output, it would pay state tax on two thirds of its profits; under the formula that double-weights sales, it would pay state tax on half of its profits. By comparison, under sales-only apportionment, it would pay no state tax if it exported all its output.

Domestic (in-state) sales. Under any of the above formulas (equally weighted, double weighting of sales, or sales only), the corporation would pay state tax on all its income if it exported none of its output.

Net effect. These results can be summarized as in the Table. The net effect of placing greater weight on sales is to reduce the tax paid on income associated with exports, while leaving the tax on income associated with domestic (in-state) sales unaffected.[21]

[13] In its comprehensive report to Congress on state taxation of interstate commerce, the Willis Committee observed that "[m]ost students of State taxation have assumed that the search for reasonable division of income rules necessarily resolves itself into a search for the 'sources' of income.'" Willis Committee Report (1964–65), p. 158. However, the Committee went on to note that a countervailing view held that the search for the "source" of income was misguided and that »the important issue is the proportion of the company's activities which take place in the each State, since 'these activities cause the state to incur the governmental costs which form the justification for its demand for a compensatory tax.« Id. at 158–59 (citation omitted). The Committee went on to point out the conflict between these two approaches, since

> [a] company with factories in two States … may conduct an unprofitable operation in one of the States by any standard which may be used for determining the source of income, but it can hardly be argued that its activities contribute to governmental costs only in the State in which its operation is profitable.

Id. at 159. On the history of the development of formula apportionment, see Hellerstein and Hellerstein (1998), Chapter 8; Weiner (1996).

[14] See Hellerstein and Hellerstein (1998), ¶ 8.06.

[15] Section 9 of UDITPA provides: "All business income shall be apportioned to this state by multiplying the income by a fraction, the numerator of which is the property factor plus the payroll factor plus the sales factor, and the denominator of which is three." Professor William J. Pierce, the principal draftsman of UDITPA, recognized that UDITPA's three-factor formula reflected both supply and demand factors and declared that the act "represents a compromise between the positions of consumer and manufacturing states." Pierce (1957), p. 781.

[16] Hellerstein and Hellerstein (2001), p. 576.

[17] Multistate Tax Compact Article I(2).

[18] Section 16(b) of UDITPA provides that sales made to a state where the taxpayer is not taxable are attributed to the state of origin. If this "throwback" rule were universally applied to foreign exports, it is less likely that sales-only apportionment would violate international trade rules, because the reduction of taxes on export income would occur only in circumstances when another jurisdiction had nexus with the taxpayer and thus a legitimate claim to tax at least a portion of that income. In any event, the wholesale adoption of the throwback rule would undercut the economic development objective of sales-only apportionment. It is worth pointing out, moreover, that many states (including, in particular those with single-factor or heavily-weighted sales formulas (e.g., Connecticut, Iowa, and Minnesota) do not employ the "throwback" rule.

[19] See McLure (1980). The effective tax rate on each factor depends on the profitability of the corporation, relative to the factor nationwide, as well as the statutory tax rate.

[20] The tax is, however, more like a multiple-stage tax on gross receipts than a single-stage retail sales tax. Again, we remind readers that our concern in this note is only with income derived from the manufacture and sale of tangible personal property.

[21] If, instead of the domestic manufacturer making foreign sales ("exports") in Table 1 we were to look at a foreign manufacturer making in-state sales ("imports"), then the fraction of income associated with in-state sales that is taxable in-state would be 1/3, 1/2, 100% under the same three formulas. We again assume that the domestic manufacturer has all of its property and payroll in the taxing state and ignore domestic payroll and property of the foreign manufacturer. It would, of course, be relatively simple for the foreign manufacturer to avoid nexus or make sales into a state without sales-only apportionment.

Fraction of income that is taxable in-state, assuming all output is sold in-state or is exported

	Domestic manufacturer making in-state sales	Domestic manufacturer making foreign sales ("exports")
Equally-weighted three-factor formula	100 percent	2/3
Double-weighted sales formula	100 percent	1/2
Sales-only apportionment	100 percent	0

Why sales-only apportionment violates international trade rules

In the case of sales-only apportionment the corporation in the foregoing example pays no tax in the state if it exports all its output, but pays tax on all its income if it exports none of its output. Thus sales-only apportionment falls squarely within the description of BTAs quoted earlier, *"fiscal measures which put into effect, in whole or in part, the destination principle* (i.e. which enable exported products to be relieved of some or all of the tax charged in the exporting country in respect of similar domestic products sold to consumers on the home market ...)"[22] (emphasis added). Since corporate income taxes are direct taxes, sales-only apportionment constitutes an export subsidy of the type prohibited by the long-established understanding of GATT 1947[23] – an understanding that should command no less respect under GATT 1994. Indeed, Article XVI(1) of the WTO Agreement provides that "[e]xcept as otherwise provided …, the WTO shall be guided by the decisions, procedures, and customary practices followed by the CONTRACTING PARTIES to GATT 1947 and the bodies established in the framework of GATT 1947."[24] Moreover, Annex I(e) of the SCM Agreement lists among the "illustrative list of export subsidies," which are generally prohibited by Article 3.1[25], "[t]he full or partial exemption, remission, or deferral specifically related to exports, of direct taxes … paid or payable by industrial or commercial enterprises."[26] In short, sales-only apportionment violates international trade rules because it produces a destination-based income tax, which constitutes a prohibited export subsidy.[27]

Is there a persuasive case for sales-only apportionment?

To overcome the prima facie case that sales-only apportionment is a prohibited export subsidy, it would be necessary to argue persuasively that sales-only apportionment accurately reflects where income originates. After all, there is nothing wrong with an income tax that attributes income to the place where sales occur, provided that income originates where sales occur. Defenders of sales-only apportionment against the prima facie case advanced above would presumably base their position on the SCM's definition of a subsidy:

[22] The same thing occurs on the import side. Sales-only apportionment falls within the prohibited class of "fiscal measures which put into effect, in whole or in part, the destination principle (i.e. ... which enable imported products sold to consumers to be charged with some or all of the tax charged in the importing country in respect of similar domestic products)" (emphasis added).
[23] See supra Part II.
[24] WTO Agreement, Article XVI(1).
[25] See supra Part II.
[26] SCM Agreement, Annex I(e).

[27] Despite the apparent subsidy for exports created by sales-only apportionment, we recognize that one may nevertheless argue that it does not constitute an export subsidy because such apportionment favors "interstate" as well as "foreign" exports. For example, if Corporation A and Corporation B, conduct all of their manufacturing operations in State X, which has adopted sales-only apportionment, and Corporation A sells all of its output to State Y while Corporation B sells all of its output to Country Z, one may contend that there is no violation of international trade rules because foreign sales are subsidized no more than domestic sales. Although this is plainly an issue that will require further exploration to determine whether the "prima facie" case set forth in this article will survive more extended scrutiny, we offer several preliminary observations at this juncture.
First, in the context of "national treatment" allegations against subnational legislation, the appropriate comparison is between treatment of in-state and foreign goods. See Canada – Import, Distribution and Sale of Certain Alcoholic Drinks by Provincial Marketing Agencies, GATT Doc. No. DS17/R (18 February 1992) (report of the panel); United States – Measures Affecting Alcoholic and Malt Beverages, GATT Doc. No. DS23/R (Feb. 7, 1992) (report of the panel). The fact that out-of-state goods are treated no better than foreign goods does not save the state legislation from condemnation under GATT. One might advance an analogous argument with regard to the treatment of interstate and foreign exports.
Second, as noted above, see supra Part II, the SCM Agreement defines a "prohibited subsidy" to include "subsidies contingent, in law or in fact, whether solely or as one of several other conditions, upon export performance," SCM Agreement, Article 3.1(a), and GATT 1947 imposes general restraints on "any subsidy … which operates directly or indirectly to increase exports ..." GATT 1947, Article XVI(1 Whether or not sales-only apportionment constitutes a "subsidy" that is "contingent, in law or in fact … upon export performance" or one that "operates directly or indirectly to increase exports" will depend, in the end, on a definitive interpretation by the WTO of the meaning of those phrases in the context of subnational measures and, in particular, whether "foreign" in that context should be construed to embrace all out-of-state sales.
Third, even if one were to conclude that (1) the "national treatment" analogy is inapposite because it deals with indirect taxes on goods rather than subsidies for direct taxes and (2) the language of Article 3.1 of the SCM Agreement and Article XVI of GATT 1947 requires a comparison between a state's treatment of all domestic sales and all foreign sales rather than between in-state and out-of-state sales, the more that the states adopt sales-only apportionment, the stronger the case becomes for establishing a violation of international trade rules. Indeed, if every state adopted sales-only apportionment, the subsidy "to increase exports" or "contingent … upon export performance" would be self-evident, however one defined exports. Consider the case of a federal tax with sales-only apportionment and the case in which all states had corporate income taxes and sales-only apportionment and assume, crucially, that nexus is not an issue. The first would clearly violate international trade rules, so the second, which is equivalent, also should.

[A] subsidy shall be deemed to exist if (a)(i) there is a financial contribution by a government or any public body within the territory of a Member (referred to in this Agreement as "government"), i.e., where … (ii) government revenue that is otherwise due is foregone or not collected (e.g., fiscal incentives such as tax credits) …; and (b) a benefit is thereby conferred.[28]

In substance, the defenders of sales-only apportionment would contend that it is not a "subsidy" at all within the meaning of the SCM Agreement, because it does not constitute revenue "otherwise due" but rather is a reasonable method of exempting income from foreign economic processes.[29] This seems to be a daunting task.

In adopting formula apportionment as the methodology for attributing income, one must accept that there is no objective standard for what is the correct apportionment formula. But one can appeal to common sense, economic analysis, judicial precedent, standard practice, the legislative history of sales-only apportionment, and federal law. None of these supports sales-only apportionment.

Common sense. The notion that only sales reflect where income is earned – that labor and capital make no contribution – is far-fetched.

Economic analysis. The common sense view that labor and capital contribute to the creation of income reflects – indeed, is probably grounded in – economic analysis. Income is the return to capital and labor. Sales are essential to the realization of income, but they are not enough, by themselves.[30]

Judicial precedent. The U.S. Supreme Court has opined that income "may be defined as the gain derived from capital, from labor, or from both combined."[31] While this statement is now regarded as an unduly narrow view of income, the notion that capital and labor should be ignored completely in determining the source of income flies in the face of the Court's observation that "the standard three-factor formula can be justified as a rough, practical approximation of the distribution of either a corporation's sources of income or the social costs which it generates."[32] We recognize, of course, as we observed at the outset of this note, that single-factor sales apportionment has survived scrutiny as a matter of federal constitutional law. But that was no ringing endorsement of single-factor sales apportionment as a method for apportioning income. To the contrary, the Court permitted a deviation from the "benchmark"[33] three-factor formula in *Moorman* only because to do otherwise would require "extensive judicial lawmaking"[34] and because Congress rather than the Court was the appropriate body to fashion such rules.

Standard practice. As noted earlier, until recently the equally weighted three-factor formula was the standard formula. "The three-factor formula … has gained wide approval precisely because payroll, property, and sales appear in combination to reflect a very large share of the activities by which value is generated"[35], and thus where income originates. Even now only a few states have shifted to sales-only apportionment. Canada uses payroll and sales, equally weighted, to apportion corporate income.

Legislative history. The states that have made the shift to sales-only apportionment have almost certainly done so only to improve their competitive position.[36] As a key economic advisor to the Governor of Georgia observed in explaining the state's adoption of a double-weighted sales factor, the legislation "offer[s] economic incentives for business expansions and locations here ... By promoting the activities of firms that have a physical presence – property and labor – in Georgia, [the legislation] should clearly have a stimulative

[28] SCM, Article 1 (emphasis supplied).
[29] See United States – Tax Treatment for "Foreign Sales Corporations," AB-2001-8, WT/DS108/AB/RW (14 January 2002) (Report of the Appellate Body).
[30] Indeed, some economists have argued that sales should be dropped altogether from the apportionment formula; see Harriss (1959); Studenski (1960), pp. 1131–32. We cite these authorities not because we necessarily agree with them but only to demonstrate the absurdity, from an economic standpoint, of the position that capital and labor may be ignored altogether in an income apportionment formula. Musgrave (1984) considered both "supply" and "supply-demand" based formulas. Although the former approach considers using only labor and capital as apportionment factors, the latter includes sales. Musgrave does not consider using only sales to apportion income.
[31] Eisner v. Macomber, 252 U.S. 189, 207 (1920) (quoting Doyle v. Mitchell Bros. Co., 247 U.S. 179, 185 (1918) and Stratton's Independence, Ltd. v. Howbert, 231 U.S. 399, 415 (1913)).
[32] General Motors Corp. v. District of Columbia, 380 U.S. 553, 561 (1965).
[33] Container Corp. of America v. Franchise Tax Board, 463 U.S. 159, 170 (1963).
[34] Moorman Mfg. Co. v. Bair, 437 U.S. 267, 278 (1978).
[35] Container, 463 U.S. at 183.
[36] The following argument is typical of this line of reasoning: "[U]nder current tax policy, a company with multi-state operations faces a higher tax bill in New York if it locates jobs and investment here. For tax purposes, New York now allocates a company's income to this state based on three factors: in-state sales (which is counted twice), in-state payroll, and in-state property. By basing corporate taxation solely on in-state sales, New York can reward, rather than punish, employers that create jobs here ..." The Wire, newsletter of the Business Council of New York State., Inc., November 24, 2000, quoted in Mazerov (2001).

effect."[37] It seems unlikely that any state has made the shift because it thought sales-only apportionment accurately reflects where income is earned.

Federal law. Under the Internal Revenue Code, when a taxpayer manufactures goods within the United States and sells them outside the United States or manufactures goods outside the United States and sells them within the United States, the income "shall be treated as derived partly from sources within and partly from sources without the United States."[38] The implementing regulations describe two methods that may be used for dividing the income from these transactions between foreign and domestic sources. Under the so-called "50-50" method, one half of the income from these transactions is allocated to production activities and one half is allocated to the sales function – essentially a two-factor apportionment formula of property and sales.[39] Under the independent factory price (IFP) method, the taxpayer may elect to allocate income between foreign and domestic sources on the basis of an independent factory price that is "fairly established" by sales to unrelated third parties.[40] These rules are significant because they provide yet another piece of evidence as to what constitutes a reasonable standard for determining the source of income derived from manufacturing in one jurisdiction and selling in another. Whatever room for debate there may be about whether the formulary "50-50" method is superior to the "arm's-length" IFP method, one thing is clear: Under no circumstances, under federal law, can a taxpayer who manufactures in one jurisdiction and sells in another assign *all* of the income to the jurisdiction of the sale, which is exactly what sales-only apportionment does.

Do international trade rules constrain state tax policy?

International trade rules derived from GATT 1947 generally have been regarded as applicable to subnational governments. GATT 1947, Article XXIV:12 provides that "[e]ach contracting party shall take such reasonable measures as may be available to it to ensure observance of the provisions of this Agreement by the regional and local governments and authorities within its territories." As an eminent American authority on GATT has observed, "Article XXIV:12 obligates the United States to compel state adherence to [GATT] ...".[41] Indeed, over the years a number of disputes involving subnational measures have arisen under GATT, including an American challenge to the practices of Canadian provinces regarding imports of beer *("Beer I")*[42] and a Canadian challenge to various U.S. national and subnational taxes and regulations applicable to alcoholic beverages *("Beer II")*.[43]

It was precisely because the international trade rules embodied in GATT and related agreements applied to subnational taxing measures that the American states expressed considerable misgivings about the impact on their taxing authority of the agreements reached during the Uruguay Round of multilateral trade negotiations.[44] While the preexisting understanding under the language and practice of GATT was that its rules applied to subnational measures, the new rules developed during the Uruguay Round for services (the General Agreement on Trade in Services (GATS)) were explicitly made applicable to subnational measures.[45] The states, speaking through the Multistate Tax Commission (MTC)[46] and the Federation of Tax Administrators (FTA)[47], objected both to the

[37] Georgia Department of Revenue, Georgia Revenue Quarterly, Vol. 17, No. 1, at 1 (1995) (quoting Dr. Henry Thomassen, economic advisor to Governor Zell Miller). Politicians and business groups in other states have expressed similar sentiments in supporting legislation to change their three-factor formulas with a double-weighted sales factor to a single-factor sales formula. See, e.g., Pratt and Goldberg (2002); (California) Plattner (2002) (New York)..

[38] I.R.C. § 863(b).

[39] Reg. § 1.863-3(b).The property factor is determined by reference to the location of the taxpayer's "production assets" within and without the United States. Reg. § 1.863-3(c)(1). The sales factor is determined by reference to the location of sales within and without the United States based on where rights, title, and interest of the seller are transferred to the buyer. Reg. §§ 1.863-3(c)(2), 1.861-7(c).

[40] Reg. § 1.863-3(b)(2)(i). Under a third approach, the taxpayer may apportion income from § 863 sales by the method it uses in keeping its books and records if it has received advance permission from the Internal Revenue Service to do so. Reg. § 1.863-3(b)(3).

[41] Hudec (1986), p. 221. see also Schaefer (2001), p. 630. Whether the trading partners of the United States can convince it to enforce their complaints against sales-only apportionment does not affect the basic issue of whether that method contravenes international trade rules.

[42] Canada – Import, Distribution and Sale of Certain Alcoholic Drinks by Provincial Marketing Agencies, GATT Doc. No. DS17/R (18 February 1992) (report of the panel).

[43] United States – Measures Affecting Alcoholic and Malt Beverages, GATT Doc. No. DS23/R (Feb. 7, 1992) (report of the panel). See also Territory of Hawaii v. Ho, 41 Haw. 565 (1957) (GATT has same effect as treaty and therefore Hawaii law in violation of GATT is preempted under Supremacy Clause).

[44] See Aune (2002); Hellerstein (1995).

[45] See GATS Art. I:3(a) (defining "measures by Members" as meaning "measures taken by ... central, regional or local governments and authorities").

[46] The MTC is the administrative arm of the Multistate Tax Compact. The Compact seeks to facilitate proper determinations of state and local tax liability of multistate taxpayers, promote uniformity or compatibility of state tax systems, facilitate taxpayer convenience and compliance, and avoid duplicative taxation. The MTC frequently supports the states' interests before judicial and legislative bodies. There are 20 state members and 19 state associate members of the Multistate Tax Compact.

[47] The FTA frequently represents the interests of states and state tax administrators before legislative bodies.

restrictions imposed by the GATT/GATS on their traditional taxing powers and to the impact of the new dispute settlement procedures under the WTO Agreement.[48] Whatever the merits of those objections, the crucial point for present purposes is the simple fact that the states made them, for it constitutes powerful evidence, if any were needed, that states are subject to the substantive discipline of contemporary international trade rules.[49]

What now?

Our purpose has been to stimulate debate, by suggesting that sales-only apportionment constitutes a prima facie violation of international trade rules. If that suggestion stands up to further analysis, one would expect the European Union and perhaps other trading partners of the United States to complain to the World Trade Organization that sales-only apportionment constitutes a prohibited export subsidy. If those contentions are sustained, sales only apportionment will have reached its high-water mark. If states want to improve their competitive position, they will need to do it honestly and transparently, by reducing corporate tax rates, perhaps replacing lost revenues with revenues from taxes levied explicitly – rather than implicitly – on payroll, property, or sales.[50]

If sales-only apportionment is proscribed, what formula would be allowable under international trade rules? This question is difficult to answer; as we noted above, the decision is, to some extent, arbitrary. It seems, however, that a formula that double-weights sales would be found acceptable; as noted above, Canada uses a two-factor formula that places half the weight on sales, as does the United States, at least in the context of goods manufactured by the seller.

[48] MTC and FTA spokesmen have expressed these concerns formally and informally to the Executive Branch, to Congress, and to the tax community through oral and written submissions. Their views are summarized in MTC and FTA (1994) and FTA (1994).
[49] The United States submitted a number of reservations to the new GATS rules (as distinguished from the preexisting GATT rules), including reservations relating to the states' use of formulary apportionment. See supra note 1. In addition, in enacting the Uruguay Round Agreements, Congress provided a number of procedural protections from GATT/GATS-based attacks on state laws, including a provision barring any "private" right of action challenging a state law under GATT or GATS. See 19 U.S.C. § 3512. Only the United States may bring such an action for the purpose of declaring a state law invalid under the Uruguay Round Agreements.
[50] Of course, those that levy sales taxes could also eliminate tax on sales to business; see McLure (2001).

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The Monetary Policy of the ECB and Automatic Stabilizers: Will they Work?

Jack W. Osman*

Jouko Ylä-Liedenpohja**

Many commentators regard the Stability and Growth Pact (SGP) of the euro economies as unduly restrictive during economic recessions because of the maximum public sector deficit of 3 per cent of GDP. Instead, Euroland is to rely on automatic demand stabilizers (ADSs) while reverting to the path of its potential growth, as frequently announced by the representatives of the European Central Bank (ECB). The interest rate policy of the ECB indirectly supports such adjustment by reducing the allocative distortions of high and variable rates of inflation experienced in the past by most euro countries, enhancing the rate of their potential growth and speeding up the approach to it.

We argue that ADSs themselves will likely not do their intended job, nor would the opening up of the SGP help. The reason is in the simple notion of the ADSs. When production and income formation contract, automatic transfers such as unemployment benefits from the government to the private sector increase and, due to the progressive income tax schedule, the average income tax rate should automatically be lower. Therefore the fall of disposable income will be smaller than that of pre-tax income which is thought to cushion the initial fall in aggregate demand whatever its source. The decelerating economic activity brings forth looser monetary policy and lower interest rates as counter forces to stimulate aggregate demand again.

This kind of reasoning is blind sophomore macroeconomics of the 1960's. Income transfers are thought to be paid out lump-sum to unemployed workers so that their labour force participation choice would be minimally distorted to facilitate the working of the expansionary monetary policy. In most countries of Euroland in particular, they are conditioned on previous earnings. When part of the earnings related unemployment benefits is not financed from actuarially fair insurance premiums paid by the workers and their employers, but from general tax money, it creates an incentive for moral hazard in the wage setting, thereby increasing the probabilities of bad states-of-the-world occurring and consequently more frequent and longer unemployment periods. Job seekers are also protected from accepting just any offered job, but the one that matches their qualifications. The poverty trap, the effective marginal tax rate of 100 per cent, is the final killer of the incentive to accept a temporary employment: the loss of unemployment benefits and other possible income support schemes together with the income taxes from the temporary employment may mean that the job seeker's post-tax income does not increase after accepting such a job.

In the case of older workers the most important incentive derives from how their prospective old age pension will develop while unemployed and after accepting a new job after a period of unemployment. If pension rights accumulate during unemployment as if one were employed at the previous, good state-of-the-world earnings, the job seeker has no incentive to accept a job offer if his take-home pay over the post-tax unemployment benefit does not compensate a lower old-age pension. This is precisely the effect of various pre-retirement schemes in which politicians pen up the older unemployed. The role of many labour market programs is only to offer a bridge to the pre-retirement schemes.

These features change the optimum of the unemployed workers' remaining life-cycle leisure-work choices from what they were before the shock. Once unemployed they are less willing to accept and search for new job offers. This increases the cost of hiring, lowers investment and leads to new higher equilibrium rate of unemployment.

Therefore the ADSs destabilize production, the supply side of economies. Keynes's effective demand, the production that the entrepreneurs predict to materialise at the intersection of aggregate demand and supply, will therefore decrease due to the force of ADSs and shocks and does not increase as assumed by the simple ADS notion. The opening-up of the SGP would in part only make the destabilizing effect of the ADSs more severe.

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Europe's laws protecting employees against easy firing operate to the same direction. Not only do they cause once laid-off workers to have a more difficult time finding jobs, and therefore a regulated labour market to take much longer to get back to the equilibrium, but the equilibrium rate of unemployment will also be higher.

In fictive models of our science, stricter firing laws do not change the equilibrium rate of unemployment because shocks, negative or positive, are infinitesimal and independent of each others and laying-off is indistinguishable from firing, and businesses can rehire experienced skilled workers. In reality, shocks are sizeable and not symmetrically distributed. Firing is a highly costly activity due to the severance pay and other compensation to unemployed workers. Hiring of new workers is also costly due to training and loss of output while learning. The shocks cause additional one-off costs when some businesses die out, spreading the shock to their suppliers and customers, and totally new firms in totally new business areas get born.

When facing the likelihood of these kinds of shocks, every firm is willing to suffer losses both in a downturn and in a boom (overtime, lost output), in order to avoid reversing its decision and paying twice the fixed cost of the trip either through the unemployment pool or through the shop floor. The more expensive the worker protection laws, the longer are the time spans of losses both in downturns and in booms. Therefore, the relatively shorter are the time spans of positive cash flows from any project, the riskier they are. Thus, the lower is the net present value of any prospective project. The businesses are simply willing to sacrifice less sunk cost and invest less under stricter employee protection laws, raising the rate of equilibrium unemployment of euro economies.

In our analysis, it is the interest rate policy of the ECB which ameliorates these effects. The financing cost of losses during recessions and booms is lower with consistent, credible monetary policy aiming at price stability. Therefore the firms will tolerate losses to last longer and do not fire employees as early as with national monetary policies. This is the phase the euro economies are currently experiencing in their business cycle. Yet, the real test of the ECB will be whether it will deliver Euroland with lower long-term interest rates than the Fed is able to do in the USA, when they eventually shoot up.

The recent rise in the external value of the euro will lessen inflationary pressures in Euroland. But, the ECB will be cautious in cutting its steering rate to not repeat its spring 1999 error and cause unnecessarily variable interest rates. For, the real purpose of monetary policy is credible, low and as non-volatile nominal and real interest rates as possible over the long term, as taught by Keynes in his *General Theory*.

Older Workers – a Neglected Employment Potential

Two longer-term demographic trends may be observed in the western industrialised countries. Birth rates are declining and the life expectancy of the population is rising. As a consequence, the age profile of the working-age population is shifting in favour of older people. In the near future, meeting labour demand with younger workers will therefore run into limits. Even today, many firms bemoan the lack of skilled labour. Greater utilisation of the potential of older workers could offer a way out.

Figure 1 shows the degree to which people of age 55 to 64 are gainfully employed. In 2001, the lowest older-worker employment ratios – below 30% – existed in Italy, Belgium and Austria. Norway, Switzerland and Sweden were at the high end, and together with Japan and New Zealand accounted for those countries where over 60% of the working population belong to this age group.

At 36.8%, Germany has an employment ratio of older workers that is relatively low. At the same time it has the highest unemployment rate of older workers, at 11.2%, among all the industrialised countries (see Fig. 2). This reveals that firms' attitude towards older workers as well as the design of the relevant labour market regulations stand in the way of the employment of older workers there. In order to increase the integration of older workers in the labour market, inducements for early retirement must be reduced. In Germany, as in other countries, early retirement used to be very popular. Since 1992, but especially as a result of the 1996 pension reform, an increase in the pension age reversed this practice. Yet, early retirement is still advantaged to a considerable degree. Large parts of society still consider early retirement a useful means for reducing unemployment.

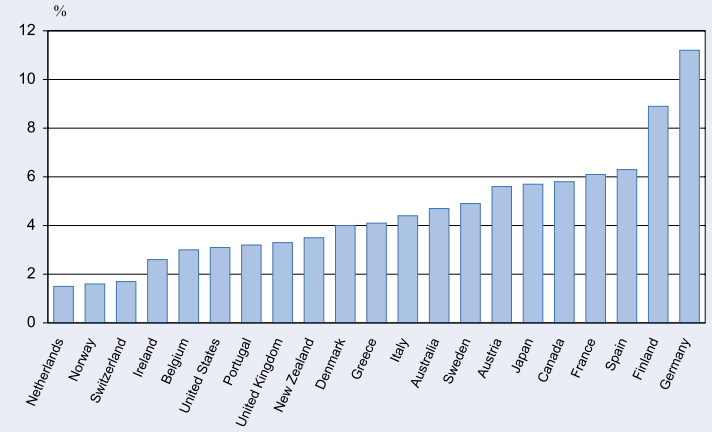
Besides cutting back the inducements for early retirement, the employment of older workers should be promoted. This could be done, for example, by reducing seniority privileges in workers' pay. Possibly, wage subsidies for hiring older workers could also be considered.

A third approach would be the increased inclusion of older workers in further education and training. Workers 50 years and older rarely participate in such measures. Including them in training measures would increase their productivity and raise their chances of employment.

W.O.

Figure 2

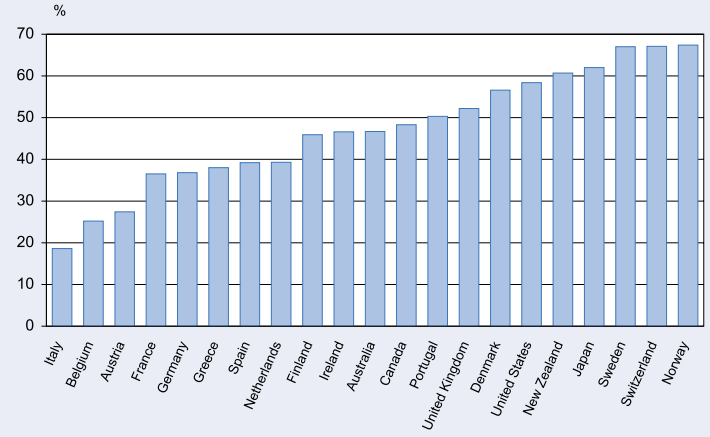
Unemployment Rates of Older Workers (55 to 64 years of age), 2001



Source: OECD Employment Outlook 2002, pp. 307-309.

Figure 1

Older-Worker Employment Ratios, 2001[a)]



a) Gainfully employed people 55 to 64 years of age in percent of the population of this age group.

Source: OECD Employment Outlook 2002, pp. 307-309.

Weak Demand for Credit, but also Weak Supply

Results of a telephone survey

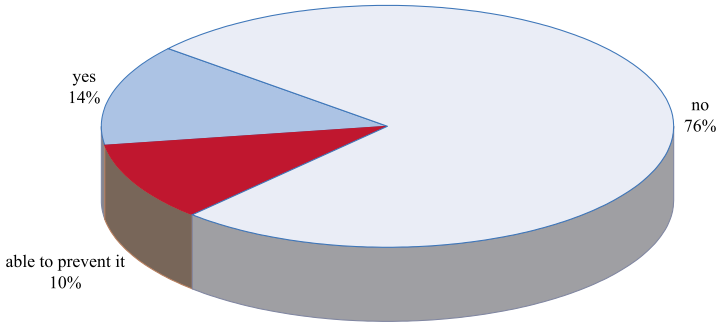
The poor investment and growth activity in Germany is frequently blamed – at least in part – on the changed lending behaviour of banks. In its Monthly Report of October 2002, the Bundesbank states that bank lending has markedly declined and is now below its year earlier level. The primary cause, however, is said to be cyclical, i.e. the weak demand for credit by business and private households, although there are indications of a certain reluctance to lend on the part of the banks. The new equity rules (Basel II) are considered to have an effect only to the extent to which they have heightened the profit and risk awareness of the banks.

In October, the Ifo Institute in co-operation with the research institute empirica–delasasse, Cologne, conducted a telephone survey of 1,100 representative firms, in order to gain additional information on the demand side.

Figure 2

Credit Supply

Question: In the past few months, were any of your loans called or were your credit lines (including overdraft facilities) reduced?



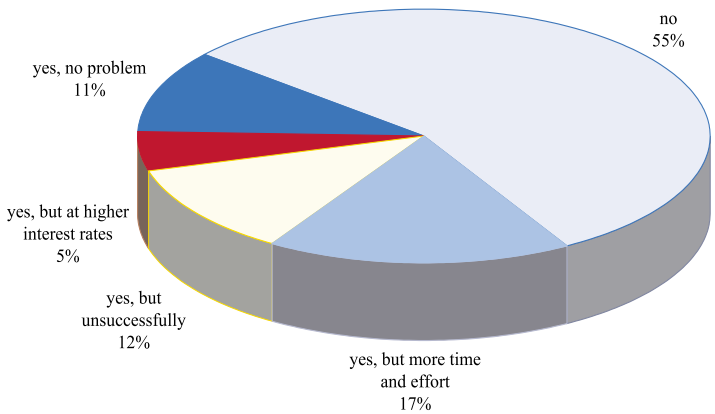
Source: Telephone survey of October 2002, Ifo Institute und empirica-delasasse.

The survey findings confirm the presently weak demand for loans. Only 45% of the surveyed firms applied for new loans or tried to extend or raise credit lines (incl. overdraft facilities) in the past few months. Only 11% of the firms met with no problems, whereas 17%, though successful, had to spend more time and effort than in the past because the banks asked for additional information regarding performance, creditworthiness, etc. Another 5% had to accept higher interest rates in order to get a new loan, an extension or an increase of a credit line. In 12% of the surveyed firms, the banks refused a loan or the firms were unable to accept the conditions (see Fig. 1).

Figure 1

Credit Demand

Question: In the past few months, did you apply for new bank loans or for an extension or increase of your credit lines (including overdraft facilities)?



Source: Telephone survey of October 2002, Ifo Institute und empirica-delasasse.

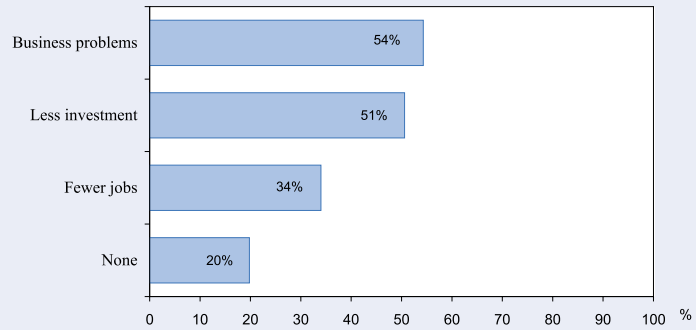
Another question asked whether the firms' loans were called or their credit lines (incl. overdraft facilities) were cut. A quarter of the surveyed firms said the banks intended to call their loans or cut their credit lines, only half of them succeeded in preventing this (see Fig. 2).

The answers to both questions permit the conclusion that the presently declining lending is not only due to the cyclically weak loan demand by business and private parties, but that the banks are more restrictive in granting new loans or dealing with existing loans.

Figure 3

POTENTIAL EFFECTS OF A RESTRICTIVE BANK LENDING POLICY

Question: If you were not granted any new loans or if your credit lines were reduced or cancelled, what would be the consequences? (Multiple answers possible)



Source: Telephone survey of October 2002, Ifo Institute und empirica-delasasse.

A third, more hypothetical question asked the firms about the effects on their business if no new loans were granted or if current credit lines were cut or cancelled. The answers show that the firms and thus the overall economy would suffer considerable hardship (multiple answers were possible). 54% of the firms said they would expect business problems, 51% would have to cut back their investment, and a good third would reduce their staff. Only 20% of the firms claimed that the refusal or reduction of a loan would not have any negative consequences at present (see Fig. 3).

H.R.

DICE REPORTS*

WORK LOST DUE TO ILLNESS – AN INTERNATIONAL COMPARISON

The economic costs of the health system are usually measured by the ratio of health expenditures to gross domestic product (GDP) or – in other words – by the contribution of the health system to GDP. Illness compared to health does not only result in a different disposition of GDP, however, say spending on health services instead of spending on other goods and services, but it also results in a lower size of GDP due to work lost due to illness. This article asks questions about

- output lost due to illness in various countries,
- the reasons for different numbers of days of illness or volume of output lost
- and the share of GDP accounted for by the total cost of illness to the economy – expenditures on health services provided and output lost – in various countries.

Number of days of illness and output lost

The primary source of the data on work lost due to illness is the OECD Health Data base. The analysis is confined to the industrialised countries. In several cases, where data are missing or not reliable, national sources are used. For some countries, like France, Italy, Spain or Ireland, the sources quoted contain no, no comparable or very dated figures.

Work lost due to illness is stated in various ways: number of calendar days, number of working days or percentage of annual working-time per employee. Where not provided, work lost was expressed in percent of annual working-time. It was assumed that, measured in this way, work lost is equal to output lost. This procedure permits only an approximation of the actual situation, however, primarily because in most cases the data refer only to employees and do not include the self-employed.[1] Table 1 contains the data on work lost due to illness and the data for calculating the percentage of working days lost in total annual working days.[2] Figure 1 is a graphic depiction of working days so lost in various countries.

There are considerable country-to-country differences. In the United States only 2% of annual working time is lost due to illness; in Australia, Canada and Switzerland it is 3% or less.[3] In contrast, the corresponding figures are 4.2% for

* DICE = Database of Institutional Comparison in Europe (www.cesifo.de).

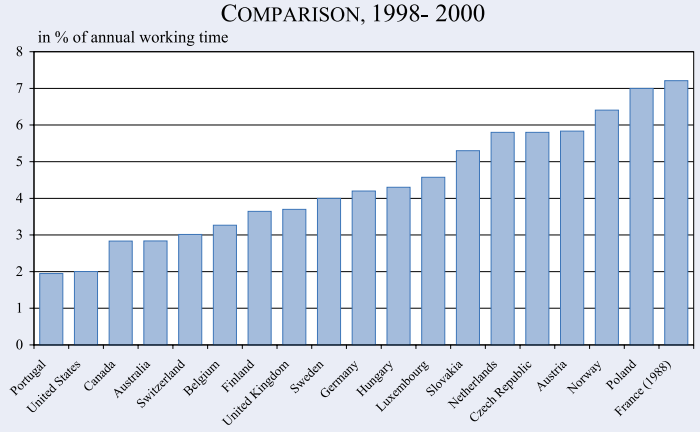
[1] Furthermore, even a comprehensive record of work lost (in percent of working-time) does not necessarily imply output lost to the same extent. This would only be the case if wages equalled the marginal value product. Even if this could be assumed, there are cases where output lost could be bigger (e.g. if machines remain unmanned) or smaller (e.g. if the illness precedes or remains without a sick certificate) than the underlying output lost due to illness. In addition, work lost due to illness is measured here as a share of actual GDP (i.e. GDP with illness), although the correct reference value is the higher GDP (i.e. without illness).

[2] The table also contains the utilisation of health services in percent of GDP and the total costs of the health system (columns 7 and 8) to which we shall refer later.

[3] The extraordinarily low percentage of work lost to illness in the United States may in part also be caused by special circumstances like the relatively low percentage of people with health insurance in the total population.

Figure 1

LOST WORKING DAYS DUE TO ILLNESS - AN INTERNATIONAL COMPARISON, 1998- 2000



Source: See Table 1 "Lost Working Time Due to Illness".

Table 1

Working days lost due to illness

	Year	Number of working days lost due to illness per employee and p.a. (1)	Working days lost in % of total annual working days (2)	Calendar days (3)	Working hours p.a. (4)	Working hours per day (5)	Working days p.a. (6)	Expenditure on health in % of GDP (7)	Total cost to to the economy of being ill in % of GDP (= (2) + (7)) (8)
Austria	1995	**6.3**	2.8	365	**1 777**	8.0	222	**11.0**	13.8
Belgium	1995	**7.1**	3.3	365	**1 739**	8.0	217	**7.9**	11.2
Germany	2000		**4.2**					**10.5**	14.7
Finland	1999	**8.0**	3.6	365	**1 757**	8.0	220	**7.9**	11.5
France	1988	**15.7**	7.2	365	**1 742**	8.0	218	**8.5**	15.7
Canada	1998	**6.6**	2.8	365	**1 863**	8.0	233	**9.3**	12.1
Luxembourg	1992	**10.1**	4.6	365	**1 766**	8.0	221	**6.6**	11.2
Netherlands	1999		**5.8**					**8.8**	14.6
Norway	1995	**14.0**	6.4	365	**1 748**	8.0	219	**7.5**	13.9
Austria	1998	**12.6**	5.8	365	**1 728**	8.0	216	**9.0**	14.8
Poland	1995	**15.7**	7.0	365	**1 796**	8.0	225	**5.3**	12.3
Portugal	1989	**4.4**	1.9	365	**1 806**	8.0	226	**7.9**	9.8
Sweden	2000		**4.0**					**9.2**	13.2
Switzerland	1997	**7.0**	3.0	365	**1 861**	8.0	233	**10.1**	13.1
Slowak Rep.	1999		**5.3**					**8.6**	13.9
Czech Rep.	1998		**5.8**					**7.6**	13.4
Hungary	1998		**4.3**					**5.3**	9.6
United States	1996	**4.8**	2.0	365	**1 916**	8.0	240	**13.7**	15.7
United Kingd.	1998	**8.5**	3.7	365	**1 839**	8.0	230	**8.0**	11.7

Notes:
Bold data on sick leaves: Official statistics.
Not bold: calculated numbers; either working days lost due to illness (1)
calendar days not worked (not shown)
or days not worked in % (2) of working days lost (1); conversion: (3) – (6).
For the conversion of calendar days to working days, where necessary, it was assumed that the calendar days per illness are distributed pro rata among working days and not working days (holidays and vacations).
Column (2): Lost output in % of GDP.
Column (7): Contribution of the health service to GDP.
Data in columns (3) to (6) are presented only if they are necessary for calculating the column (2) data.
Timelines of information: The table contains the most recently available and internationally comparable figures.

Sources: Column (1). (2). (7): *OECD Health Data 2000* and information from country specific sources.
Column (4): *World Competitive Yearbook*.

Germany, 5.8% for Austria, and close to 9% in Poland.

In some countries sick leaves are measured in terms of the sick certificates provided by doctors. Here calendar days are counted. They are then converted into "sick days in percent of total working days" as published in the statistics. This is not identical, however, to the number of sick days of the working population as a whole. In most countries, the published aggregate statistics only contain the sick leaves of employees insured by statutory health insurance. Self-employed or privately insured employees are not included. If their sick leaves were different from those insured by statutory health insurance, the sick leaves of the entire working population would also be different and probably lower than reflected in the official statistics on sick leaves.

On the other hand, the official statistics are too low in that they contain only those cases of disability caused by illness certified by a doctor. In many countries, such a certificate must only be presented after the illness has lasted several days. The number of sick days not recorded because of this may be considerable. For example, in Germany, where a sick certificate must be presented after the fourth day, about 30% of all reported cases of illness last up to three days, corresponding to a share of 8% in total reported sick days.[4]

[4] Federal Association of company health insurance firms.

Possible reasons for differences in the number of sick days

There is a large number of reasons for working days lost due to illness in a particular country. Among these are the conditions resulting in illness like the availability of protective measures at the work place. Also of importance is how well and how fast illnesses are cured. Finally, a role may also be played by the particular regulation of sickness pay. We shall focus on the second and third determinant mentioned.

How fast and well new illnesses can be cured depends on the quality of the national health service. The quality of treatment and the length of time one must wait for treatment are of great importance for the number of sick days. Of course, the "quality of the health service" is a most complex indicator which can only be represented here in very simplified form, i.e. by the expenditures on health services relative to GDP.[5]

Figure 2 shows a negative correlation between sick days and spending on health services which is, however, not very close.[6] By and large, the higher the share of health service spending in GDP (i.e. the higher the quality of the health service), the lower is the percentage of sick days.[7]

Besides the quality of the health service, the level of continued pay is also likely to be an important determinant of the volume of work lost due to illness. Data on continued pay[8] contain many institutional details that are not always directly comparable. In order to create comparability and present the data in a meaningful way, the data were converted in such a way that income or income lost, respectively, on certain individual days of illness can be ascertained.[9] Table 2 presents the various rules for continued pay.

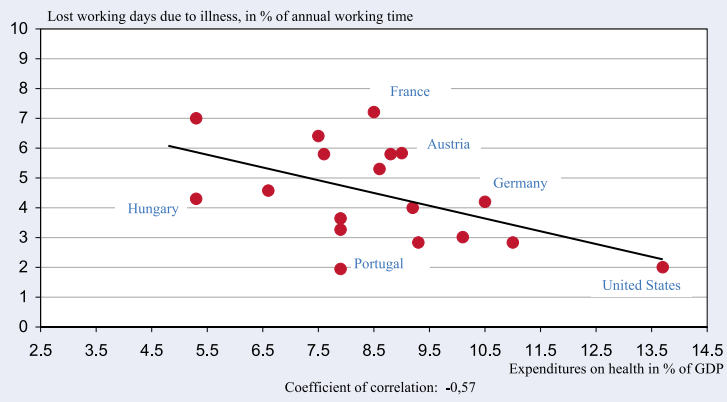
There are considerable country-to-country differences in continued pay, especially during the first to third days of illness. Here continued pay varies from 0% to 100%. 0% corresponds to one qualifying day, i.e. one day without continued pay. In five of the 18 countries under consideration, there are one or more qualifying days, in the United States even seven. On the 50th or 100th day of illness the differences are far smaller. In Norway and Luxembourg even then 100% of income is paid, whereas in most countries the sick then receive between 50% and 90% of wages.

The information on the various systems of continued pay presented in Table 2 is already a simplification of the complex nature of these rules. In order to relate the number of sick days to the kind of continued pay system, the latter had to be condensed into one single variable that is the result of a comprehensive assessment of the generosity of the continued pay systems. This assessment focuses primarily on the rules for the initial days of illness. The rules are divided into three groups: not so generous, medium generous, very generous. The relationship with the number of sick days is shown in Figure 3.

A comparison of the percentage of sick days in the two groups of countries with medium and very generous continued pay systems shows that the differences are minor, although the cases of Poland and Belgium don't fit the supposed relationship. If these outlyers are excluded, there is a clear trend toward more sick days in more generous systems of continued pay. This trend is

Figure 2

LOST WORKING DAYS DUE TO ILLNESS AND THE EXPENDITURES ON HEALTH, 1998- 2000



Source: See Table 1 "Lost Working Time Due to Illness".

[5] This indicator was chosen as an approximation because it measures the input whereas "quality" characterises the output.
[6] Correlation coefficient of – 0.57.
[7] The share of health services in GDP depends in turn also on the level of income per capita, as health is a superior good.
[8] OECD (2000) and own research.
[9] For the recurrence of an illness within one year, the rules vary from country to country.

Table 2

Sick leave payments, as a percentage of earnings, 2000

	At 1st day	At 2nd day	At 3rd day	At 10th day	At 20th day	At 50th day	At 100th day	Total valuation of generosity of sick leave pay
Austria	100	100	100	100	100	100	50	low
Belgium	100	100	100	100	100	60	60	high
Finland	70	70	70	70	70	70	70	medium
Germany (2001)	100	100	100	100	100	70	70	high
GDR (1998)	90	90	90	90	90	50	50	high
Luxembourg	100	100	100	100	100	100	100	high
Netherlands	70	70	70	70	70	70	70	medium
Portugal	0	0	0	65	65	65	65	low
Sweden	0	80	80	80	80	80	80	medium
United Kingdom	0	0	0	Not calculable per day; upper limit at about 50% of average income				low
Norway	100	100	100	100	100	100	100	high
Switzerland	0	0	0	According to enterprise or branch specific contract				low
Czech Republic	50	50	50	69	69	69	69	medium
Hungary	80	80	80	80	70	70	70	medium
Slovakia	70	70	70	90	90	90	90	medium
Poland	80	80	80	80	80	80	80	medium
Australia	Not calculable per day; upper limit at about 50% of average income							low
United States	0	0	0	60	60	60	60	low

Notes:
Germany: Figures in the table relate to new regulation in force since January 1999. In the preceding period of October 1996 till December 1998 minimum sick leave payments were set at 80 which, however, were increased to 100% in several enterprise and branch wage contracts.
United States: Regulations differ between states and even countries. The table contains plausible medium-range values. Start of sick leave payment is often only at the 8th day of sickness. More generous regulations are found in governments.
France and *Canada* were omitted here due to missing or unplausible data.

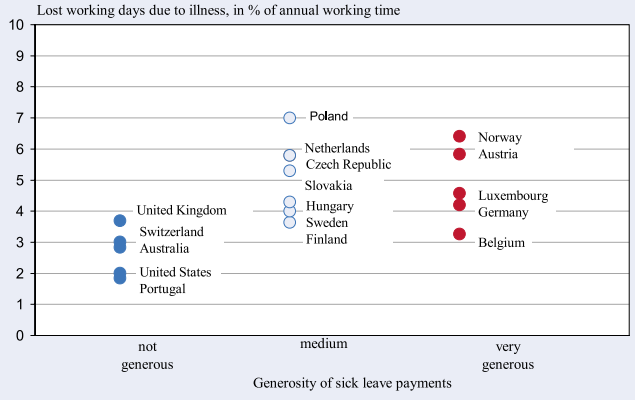
Sources: Social Security Programs Throughout the World of the US Government; Database MISSOC of the European Commission; Ifo Country Data Research; Re-calculatiion of the data, presentation and valuation: Ifo Institute for Economic Research, Munich.

stronger yet if we compare the not so generous with the medium generous and very generous countries.

There are various other factors which affect the number of sick days, but were not analysed statistically. Thus, the higher the labour force participation rate, especially of women, the more frequent may be the cases of sick children being cared for at home by their mothers or fathers who then call in sick. Furthermore, official and legal second jobs as well as activities in the underground economy may result in additional (incorrect) sick leaves in the first job. Thus, the extraordinarily high number of sick days in Poland (last available data from 1995: 8.9% of working time) may in part be due to the fact that some Poles take sick leave, receive 80% of their wages in sick pay and then go to work abroad.[10] Satisfaction at the work place should also play a role for the

Figure 3

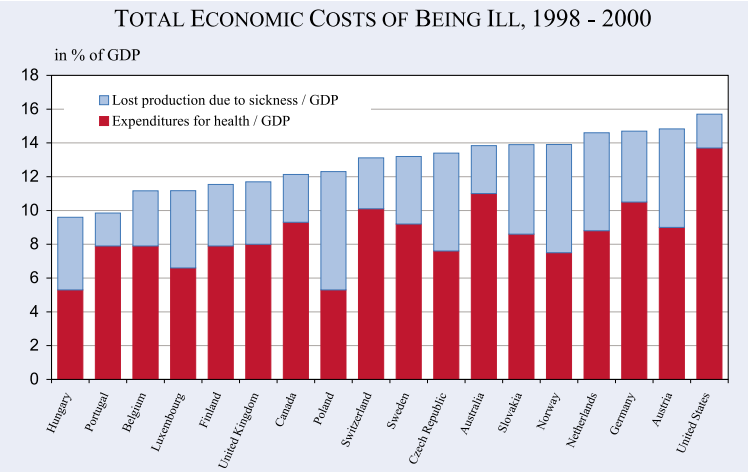
LOST WORKING DAYS DUE TO ILLNESS AND THE GENEROSITY OF CONTINUED PAY, 1998- 2000



Source: See Table 1 "Lost Working Time Due to Illness".

[10] As part of the Polish health system reform started in 2000 it is planned to have the sick leaves certified by doctors reviewed by special physicians who enjoy the trust of the authorities and business.

Figure 4



Source: See Table 1 "Lost Working Time Due to Illness".

duration of illnesses.[11] The state of the business cycle and the related risk of losing one's job is also important. Finally, there are demographic factors like the age composition of the population as well as the ratio of handicapped.

The total costs of being sick

Finally, the data on output lost due to illness and the data on expenditures on health services are added, as shown in Figure 4.

If the total costs to the economy are taken into consideration, the country-to-country differences are somewhat smaller, reflecting the fact that the size of health service costs tends to have a favourable effect on the length of sick leaves. The United States is now at the top (15.7%)[12], closely followed by Germany. Hungary and Portugal are at the bottom of the list (9.6%).

Outlook

Among the numerous possible reasons for work lost due to illness only two were highlighted here. Other factors were mentioned, but not analysed. There is, therefore, ample room for further research. Economic policy conclusions for a particular country, especially with respect to the effect of a change in the duration and volume of continued pay, should not be drawn hastily. In view of the relationships shown above it seems reasonable, however, to assume that generous rules for continued pay are being exploited[13], but other factors that were not analysed may also be significant. Furthermore, besides cross-section analyses time-series analyses are also needed.

Rigmar Osterkamp

[11] Large companies in Germany report on relevant findings and efforts (Bertelsmann Foundation/Hans-Böckler Foundation, 2000).
[12] The United States are level with France whose data are very dated, however (1988).

[13] This may be due to moral hazard or to incorrect behaviour.

World Economic Survey

World Economic Climate worsened further

In the fourth quarter of 2002, the world economic climate continued to worsen to 86.8 (1995 = 100), after having improved at the end of 2001 and in the first two quarters of 2002. The deterioration of the overall climate indicator is mainly driven by the still declining expectations for the next six months, but the assessment of the current economic situation, the second component of the climate indicator, has also weakened since mid-2001. The delay of the recovery must be seen in the context of increased geopolitical instability due to world-wide terrorism and the Iraq crisis.

World economy: Sharp setback of climate indicator

After just a small dip of the climate indicator in the July survey, the downturn accelerated in the period from August to October. Turbulence in international financial markets and uncertainty caused by the Iraq crisis had a strong negative impact on the world economic climate (see Figure 1).

United States: Further deterioration of the economic climate

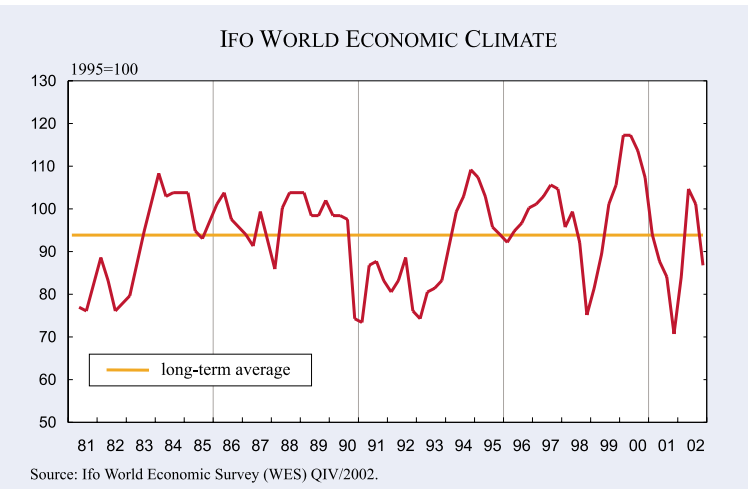
The economic climate, which had continuously risen since the end of last year, experienced a setback. This is due to a negative assessment of the current economic situation and more cautious, but still positive, expectations for the next six months. The US recovery has clearly lost momentum. This is the result of the unsatisfactory level of capital expenditure which is, however, expected to improve in the near future. In contrast, consumer demand, which had been buoyant in the past, is expected to slow down. The WES correspondents expect an increasing deficit in the trade balance, mainly caused by declining exports and stagnating imports.

Western Europe: Economic recovery stalled

The climate indicator for Western Europe is still declining, which is due both to negative expectations for the next six months as well as to an unsatisfactory assessment of the present economic performance. The latter deteriorated in almost all western European countries. Whereas Austria, France, Germany, Italy, the Netherlands and Switzerland suffered a steeper than average decline in their current economic performance, Belgium, Greece and Spain are just entering "unsatisfactory" territory.

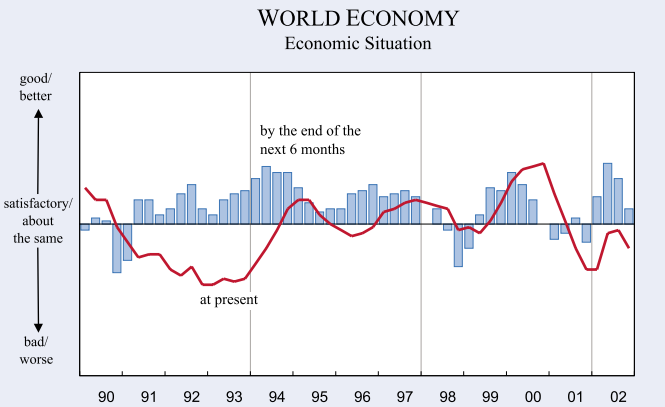
In contrast, the non-euro countries Denmark and Norway seem to be doing much better, and the United Kingdom and Sweden were judged as having a relatively positive current economic situation. Economic expectations for the next six months are considered worse than the euro area average.

Figure 1

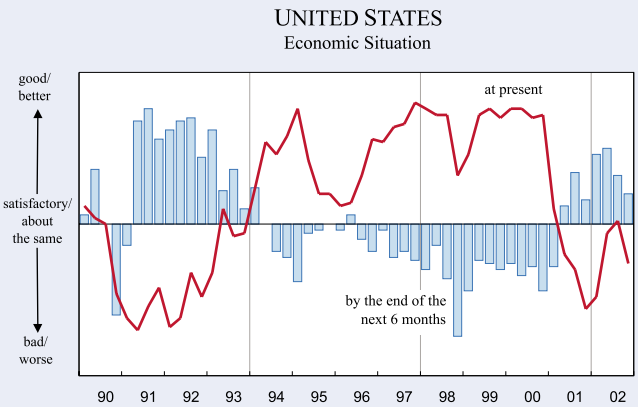


Source: Ifo World Economic Survey (WES) QIV/2002.

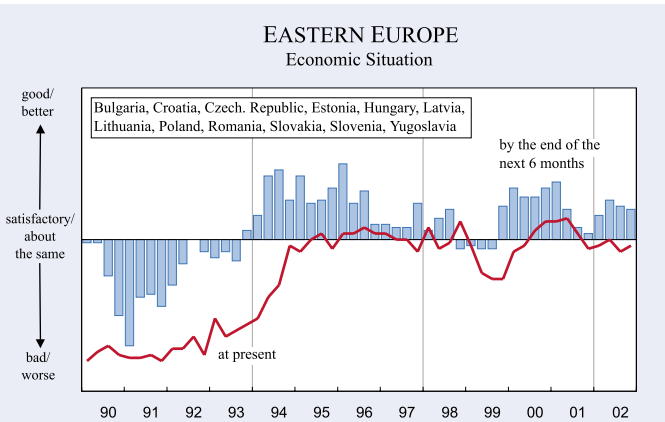
Figure 2



Source: Ifo World Economic Survey (WES).



Source: Ifo World Economic Survey (WES).



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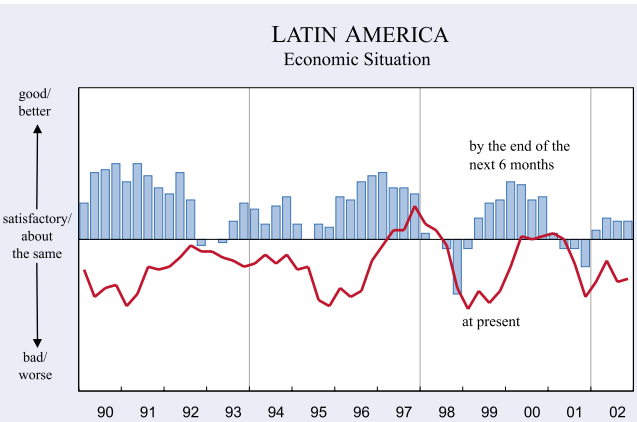

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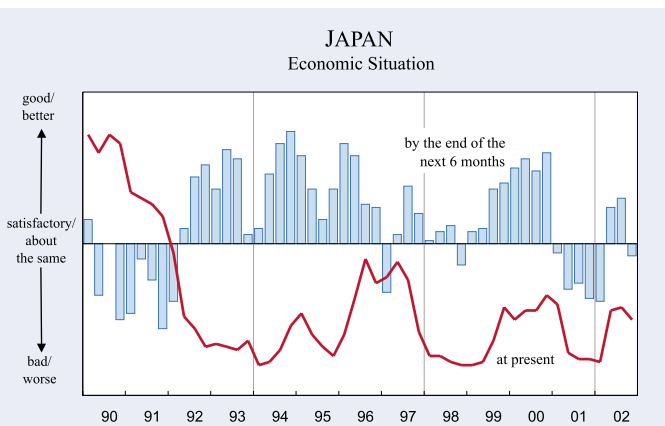
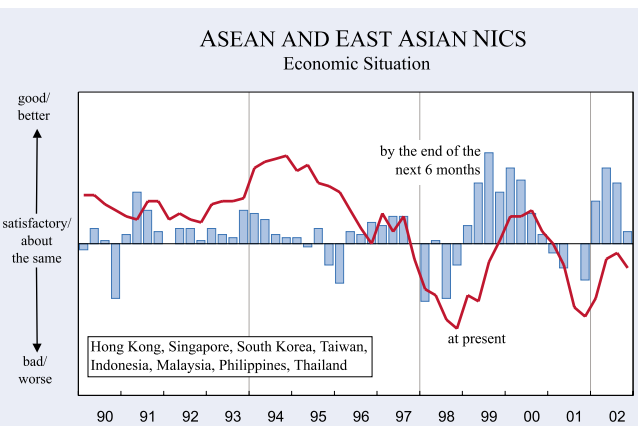


Source: Ifo World Economic Survey (WES).



Source: Ifo World Economic Survey (WES).

Among the eurozone countries, only Finland and Ireland have a satisfactory to good assessment of the present economic performance. Expectations, although declining, remained mostly positive in the euro area.

Germany again had the lowest assessments of capital spending and private consumption. With respect to the overall economy, Germany shares the lowest rating of all EU countries with Portugal, Luxembourg and the Netherlands. WES correspondents still expect a recovery in the next six months in these countries, too.

Eastern Europe: Economic climate indicator remains stable

Assessments of the current economic situation improved over the previous survey, although they remained slightly below satisfactory. The optimism regarding the outlook for the next six months was mostly maintained so that the economic climate indicator improved a bit. The current state of the economies continued to be rather good, particularly in the Baltic countries (Latvia, Estonia and Lithuania), but also in Slovenia, Hungary and the Slovak Republic. The situation in the Czech Republic worsened a bit, but is still regarded satisfactory, whereas the outlook now appears clouded. In Poland, Roumania and Yugoslavia, present economic performance is judged to be below satisfactory, but is believed to improve during the next six months.

Latin America: Unsatisfactory current economic performance

The economic climate indicator stagnated at the unsatisfactory level of the previous survey. Brazil, Costa Rica and El Salvador currently have the relatively best performance which is also expected to continue during the coming six months. In Argentina, assessment of the present economic performance improved slightly from a very low level. Expectations for the next six months remained unchanged, indicating an only slow recovery from the severe currency and banking crisis. In Uruguay and Guatemala, current economic performance is rated poor and is not expected to improve in the near future. Economic performance deteriorated in Chile and Mexico; expectations for the next six months, although lower than before, are still in the positive range. WES experts in Ecuador and Paraguay rated the present economic performance as unsatisfactory and also expect further deterioration in coming months.

Japan: Still deteriorating

The Japanese economy's current performance was rated even lower than in the previous survey, as capital spending deteriorated further and private consumption improved slightly, both still moving at a very low level. Expectations for the next six months also slipped below the satisfactory level with assessments of future investment and consumption declining from their July levels. The trade balance, which was thought to improve in July, is now expected to remain roughly unchanged.

Asean and East Asian NIEs: Economic Climate is cooling off

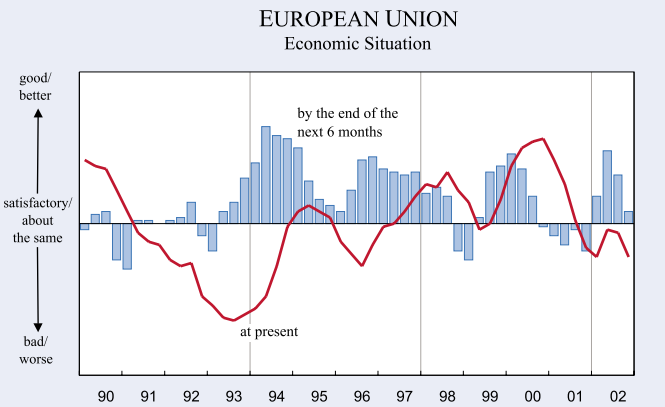
According to the October survey, assessments of the current economic situation were lower than in July. Exceptions are Hong Kong and Singapore, the latter moving into the satisfactory territory again. In the other countries of the region, economic performance deteriorated; only in the Philippines did it remain unchanged.

Over the next few months WES respondents expect the economic situation to improve in Malaysia, Hong Kong and Taiwan, to stay about the same in the Philippines, Singapore and Thailand, and to deteriorate in Korea and Indonesia.

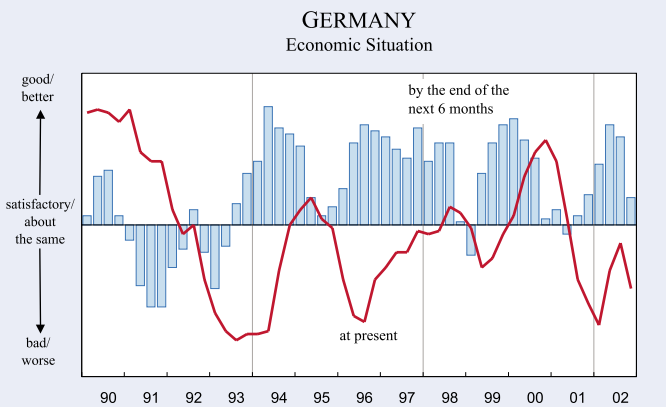
Interest Rates: Short-term interest rates to decline

More panellists than in the previous survey expect short-term interest rates to fall in coming months. A spectacular opinion swing from expected rate hikes to possible rate cuts can be observed in Hong Kong, Turkey and Western Europe (with the exception of Finland and Switzerland, where the upward trend is expected to continue). The expected downward trend of short-term interest rates is particularly pronounced in Eastern Europe with the exception of the Baltic states and Hungary, where interest rates are believed to rise. In Asia the prevailing view is that short-term interest rates will

Figure 3



Source: Ifo World Economic Survey (WES).



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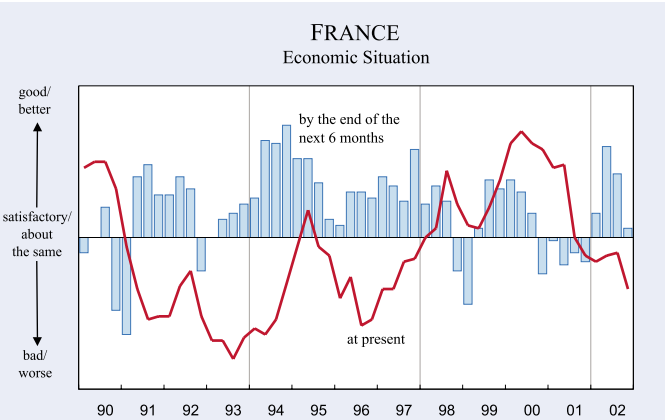

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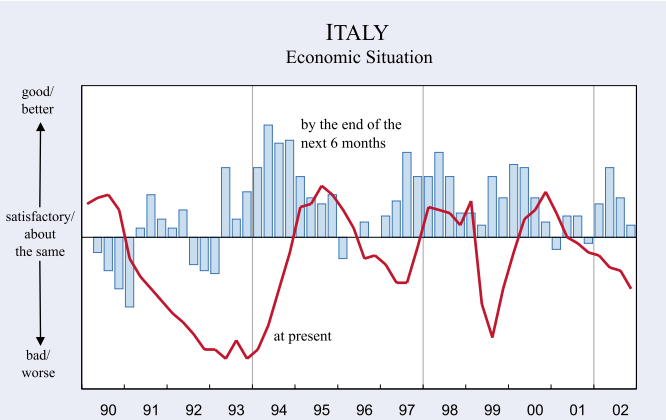

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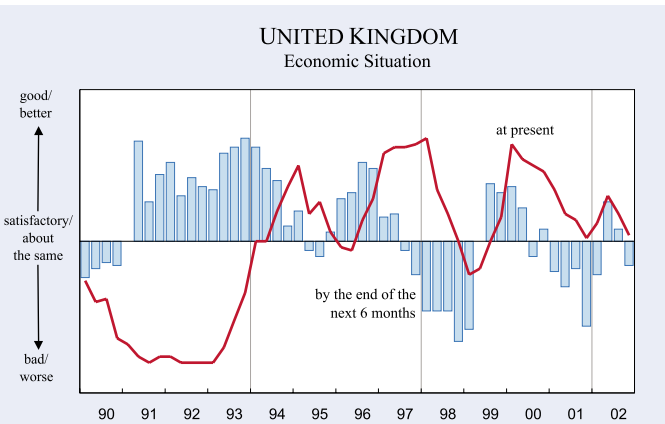

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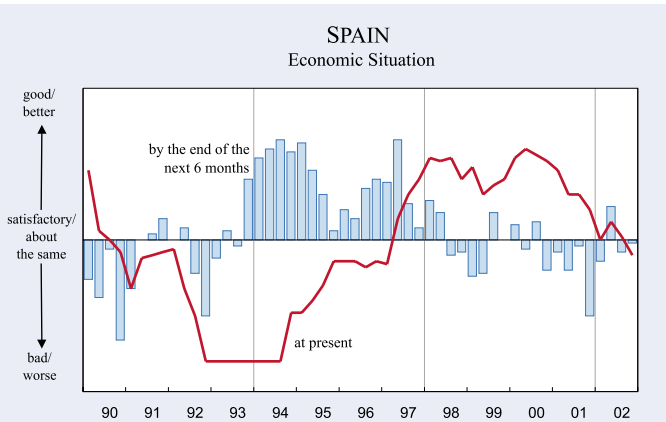


Source: Ifo World Economic Survey (WES).

decline or remain unchanged in coming months. A downward trend of interest rates is also expected in the Near East; only in Israel and the United Arab Emirates do the WES experts expect a rise. In contrast, a continued upward trend of short-term interest rates is expected in Australia, New Zealand, South Africa and Canada and most Latin American countries except Chile.

Long-term interest rates are expected to increase only marginally in the course of the next six months. A more pronounced tendency is expected in North America, Australia and New Zealand as well as in Japan, Korea, Vietnam, Thailand and in most countries of Latin America (except for Brazil and Argentina). In Western Europe, WES experts do not expect any significant changes in the coming months. In Eastern Europe, most countries will follow a downward trend of long-term rates. The same is true of the Near East . Only Israel, Lebanon and the United Arab Emirates expect an increase in long-term rates.

Inflation: On a downward trend world-wide

World-wide consumer price inflation is now seen to be 3.2% in 2002 compared to 3.6% a year ago. In Western Europe, inflation expectations are 2.2% in 2002, only slightly higher than the price target of the European Central Bank. There is, however, a big disparity of inflation rates across Europe: About half of the euro area countries (Austria, Belgium, Finland, France, Luxembourg and Germany) are expected to meet or fall below the 2% mark. Almost all of the other countries are more than 1 percentage point above the ECB target.

The latest survey places 2002 inflation in the United States slightly higher than the previous survey. At 2.2%, the US inflation rate is still within the range which the Fed regards as normal.

Asia continues to have the highest degree of price stability. There is deflation in Japan (expected inflation rate in 2002: – 0,8%) and Hong Kong (– 2.1%). China and Taiwan are also in danger of entering a deflationary cycle with inflation expected to come in at 0.7%).

The inflation outlook for Central and Eastern Europe has improved since April from 5.9% to 5.3%. The only countries in this region with very high rates of inflation are Yugoslavia (17.3%) and Romania (21.2%).

High and rising rates of inflation are also expected in some Latin American countries, especially in Uruguay (from 20% expected in July to 26.6% in October) and Paraguay (from 10.3% expected in July to 15% in October) and more modest increases in Bolivia, Brazil, El Salvador and Venezuela. Inflation is expected to remain unchanged in Chile, Colombia, Costa Rica, Mexico and Panama. Inflation is still very high in Argentina, though expected to decline (from 87.5% in July to 62.3% in the October survey).

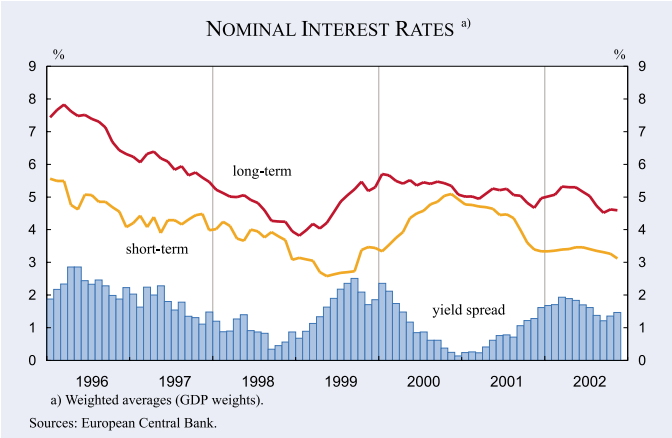
Currencies: Moving to a more stable equilibrium

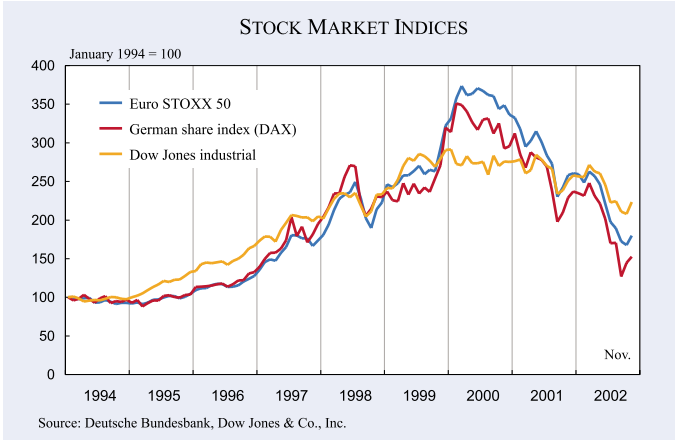
On average of the 89 countries polled, the US dollar and the British pound sterling are still judged to be overvalued, but less so than previously. The euro, on the other hand, is said to have almost reached an appropriate level. According to the WES experts, such a level has already been reached by the Japanese yen.

In Western Europe, Canada and Australia the US dollar is considered overvalued against own currencies. In Eastern Europe and Russia, the major currencies are seen to be close to “fair value” against local currencies, except in Poland, Lithuania, Slovenia and Slovakia, where the experts rated the US dollar as clearly overvalued against local currencies. In Latin America, the US dollar, the euro and the yen are considered to be near “fair value”. However, following sharp devaluations, the currencies of Brazil, Chile and Bolivia now appear to be undervalued. In contrast, in Mexico, Guatemala, Costa Rica and Peru, the currencies are overvalued relative to the major world currencies. The South African rand appears to be undervalued, however.

By the end of the next six months, the US dollar is predicted to be generally unchanged or have risen. This does not apply to Western Europe and some East European countries, Canada, Brazil, Chile, Australia and New Zealand as well as some Asian countries like Hong Kong, Malaysia and Pakistan. In Japan, where in the previous survey the experts had expected the US dollar to rise against the yen, the outlook has now changed in favour of a likely stabilisation of the yen/dollar rate.

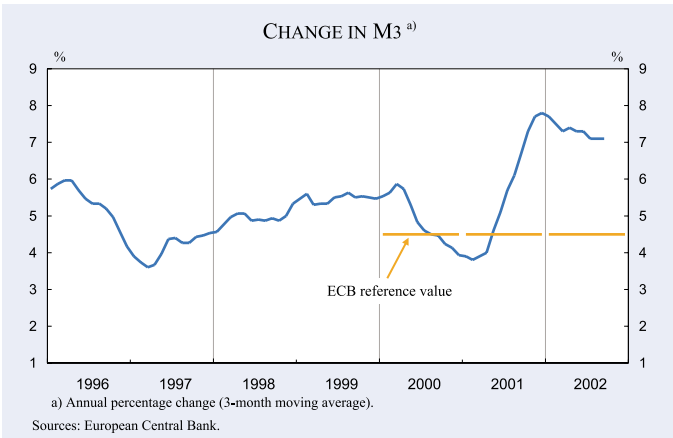
Financial Conditions in the Euro Area



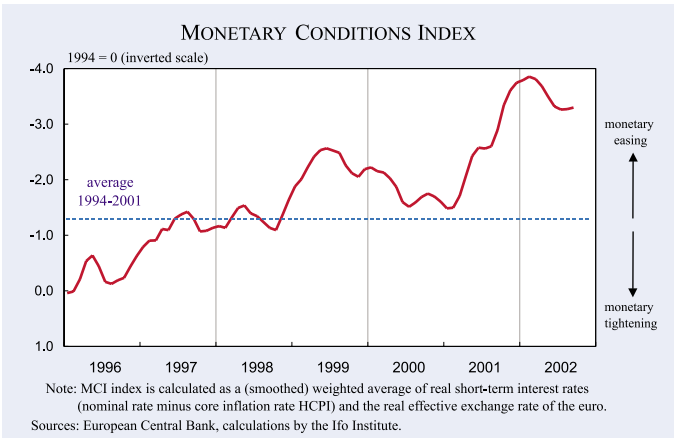


Short-term interest rates have been declining slowly until, on 5 December, the ECB finally cut key interest rates by 50 basis points to 2.75% for main refinancing operations. Long-term rates (ten-year government bond yields), which had declined to 4.5% between May and September, mainly due to flight-to-safety portfolio shifts from highly volatile stock markets, rebounded in October, to 4.6%. As a result, the yield spread widened to 1.5 percentage points.

In 2002, the major stock price indices moved closely together, with the Dow Jones Industrial index declining least. Stock prices may have bottomed out in October, when the Dow hit 8,048 and the Euro Stoxx 500 fell to 2,384.7. The German DAX had reached a low in September, at 2,769. All three indices rose again in November.



In the euro area, the growth of the broad money stock M3 has declined very slowly to an annual rate of 7.1% (3-month moving average). It thus still exceeded the ECB reference value by a wide margin.

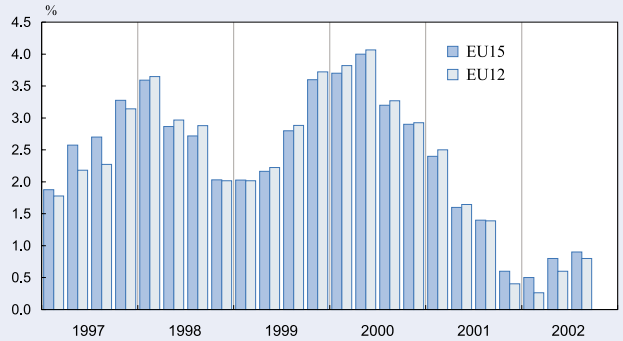


The monetary conditions index, which had declined continuously since March, indicating less monetary easing, stalled in September. The recent cut in key interest rates may increase monetary easing unless offset by the exchange rate of the euro.

EU Survey Results

Gross Domestic Product in Constant 1995 Prices

Percentage change over previous year

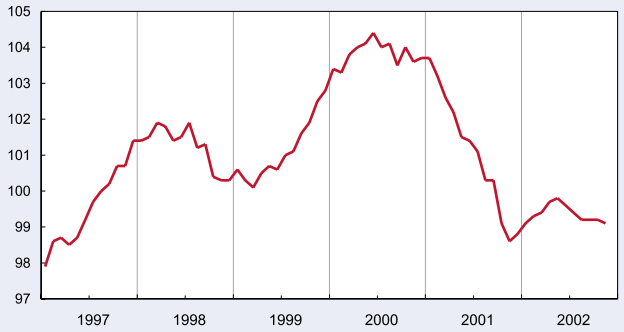


Source: Eurostat.

Initial estimates for the third quarter of 2002 show GDP growth of 0.3% in the euro area and 0.4% in EU 15 compared with the preceding quarter. The same growth rates had been observed in the previous quarter. In a year-on-year comparison, GDP growth amounted to 0.8% in the euro area and 0.9% in EU 15, following rates of 0.6% and 0.8%, respectively, in the second quarter.
Greece, the UK and Spain grew the fastest, the Netherlands, Germany and Italy the slowest. Private consumption rose faster than before in both areas, whereas investment remained roughly unchanged (after having declined six quarters in a row). Exports and imports rose equally by 2.2% in the euro area and by 1.5% and 1.6% in EU 15.

EU Economic Sentiment Indicator

Index 1995 = 100, seasonally adjusted



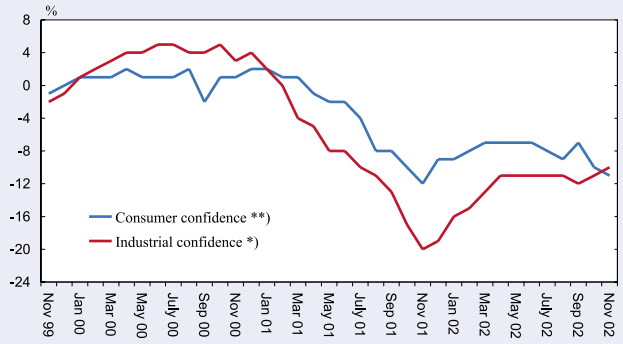
Source: European Commission.

[a] The new economic sentiment indicator is based on the industrial, construction, retail trade and consumer confidence indicators. Seasonally adjusted data.

The economic sentiment indicator for the EU declined slightly in November to a value of 99.1, after having stabilised at 99.2 between August and October. It rose in Belgium, Finland, the Nehterlands, Sweden, Greece, Italy and the UK. It remained unchanged in Denmark, Spain and France, but declined in Germany, Ireland, Portugal and Austria.

EU Industrial and Consumer Confidence Indicators

Percentage balances, seasonally adjusted

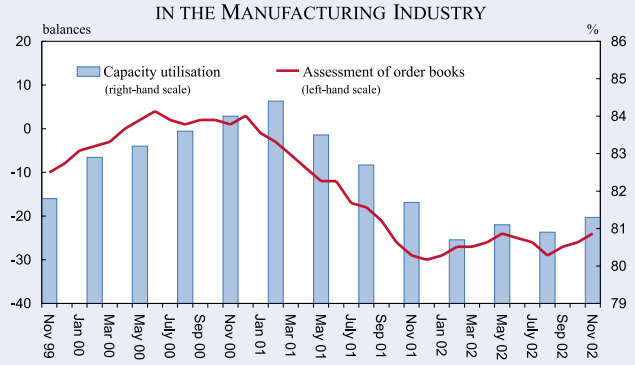


Source: European Commission.

* The industrial confidence indicator is an average of responses (balances) to the questions on production expectations, order-books and stocks (the latter with inverted sign).
** New consumer confidence indicators, calculated as an arithmetic average of the following questions: financial and general economic situation (over the next 12 months), unemployment expectations (over the next 12 months) and savings (over the next 12 months). Seasonally adjusted data.

Whereas the **consumer confidence indicator** continued to fall, the industrial confidence indicator continued to rise. The consumer confidence indicator decreased by 1 point, most in Germany (6 points) and Ireland (4), but also in Denmark and France (1). It increased slightly in the Netherlands, Austria, Portugal and Sweden (2) and in Italy, Finland and the UK (1).
The **industrial confidence indicator,** which increased by 1 point in the EU, increased in Finland (5 points), the UK (4), Luxembourg (3), Belgium, Denmark, Greece, Spain, the Netherlands, Sweden (2), France and Italy (1). It decreased in Austria (4), Portugal (3) and Ireland (2). In Germany, industrial confidence remained stable.

EU Capacity Utilisation and Order Books in the Manufacturing Industry

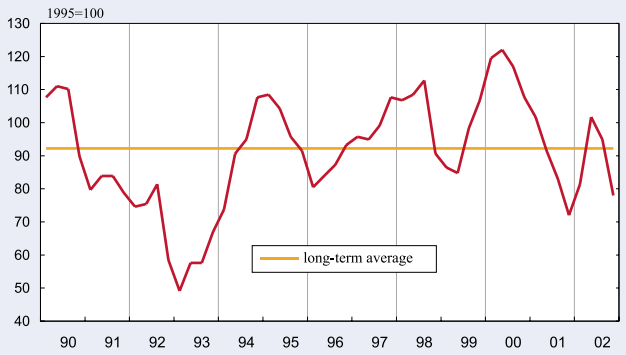


Source: European Commission.

Capacity utilisation in manufacturing rose from 80.9 in the third quarter to 81.3 in the fourth, hopefully signalling a true turnaround. Assessments of order books improved for the fourth time in a row, but they were still considered much too low. Order books improved significantly in Belgium, Denmark, Spain, Ireland, Finland and the UK, and more moderately in France, Italy and the Netherlands. They fell substantially in Luxembourg, Austria and Sweden.

EURO AREA INDICATORS

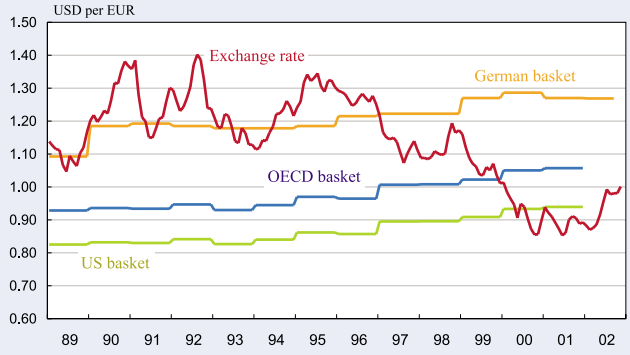
IFO ECONOMIC CLIMATE FOR THE EURO AREA



Source: Ifo World Economic Survey (WES) QIV/ 2002.

This indicator, which the Ifo Institute derives from its World Economic Survey (WES), continued to deteriorate to 78 in the fourth quarter, having peaked at 101.7 in the second quarter. The deterioration was primarily the result of the worsened assessment of current economic performance. Expectations for the next six months also declined, but remained mostly positive.

EXCHANGE RATES OF THE EURO AND PPPS



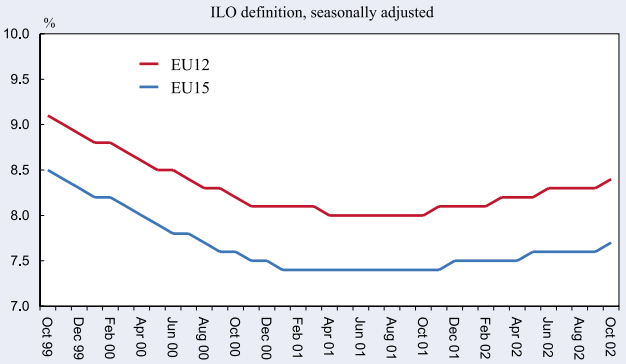
Sources: European Central Bank, Federal Statistical Office, OECD and calculations by the Ifo Institute.

a) BIS calculations; to December 1998, based on weighted averages of the euro area countries' effective exchange rates; from January 1999, based on weighted averages of bilateral euro exchange rates. Weights are based on 1990 manufactured goods trade with the trading partners United States, Japan, Switzerland, United Kingdom, Sweden, Denmark, Greece, Norway, Canada, Australia, Hong Kong, South Korea and Singapore and capture third market effects. Real rates are calculated using national CPIs. Where CPI data are not yet available, estimates are used.

In November and early December 2002, developments in exchange markets saw the euro appreciate against all major currencies. Particularly pronounced was the appreciation against the Japanese yen and, to a lesser extent, against the US dollar.

UNEMPLOYMENT RATE

ILO definition, seasonally adjusted

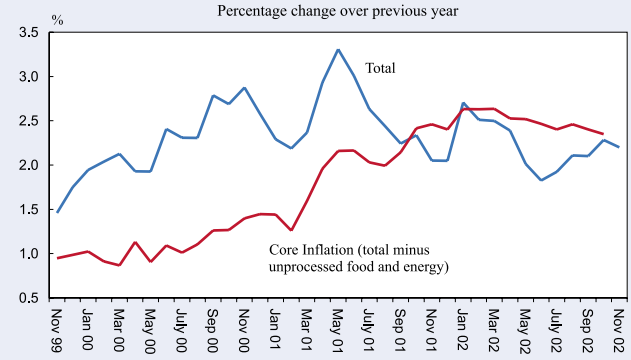


Source: Eurostat.

The unemployment rate continued its slow but steady rise in both, the euro area and the wider EU. In October it averaged 8.4% in the euro area and 7.7% in the EU 15 group of countries. A year earlier it had stood at 8% and 7.4%, respectively.

INFLATION RATE (HICP)

Percentage change over previous year



Source: Eurostat, Ifo Institute.

The year-on-year HICP inflation rate of the euro area, which had risen since June 2002 to reach 2.3% in October, declined to 2.2%, according to preliminary figures for November. It is likely to remain above 2% for some months, but is expected to decline below 2% in the course of 2003, conditional on relatively stable oil prices and on labour costs not accelerating further. Euro area core inflation (i.e. excluding unprocessed food and energy) has declined continuously since last April.

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International Spring Conference: »Prospects for the European Economy«

Thursday and Friday
20-21 March 2003
Palais am Festungsgraben
Berlin

Preliminary Programme

March 20, 2003

12:00 Cold buffet lunch

13:15 **Welcome and Introduction**
Hans-Werner Sinn, President,
Ifo Institute for Economic Research, Munich

13:30 **The World Economy with Special Reference to the United States**
Flemming Larsen, IMF Europe, Paris

13:50 **The European Economy**
Hans-Werner Sinn

14:10 **The Outlook for Central and Eastern Europe**
Willem H. Buiter, EBRD, London

14:30 Discussion

15:00 Coffee break

15:30 **China and the Asian NIEs**
Markus Taube, University of Duisburg

15:50 **The Asset Price Bubble**
Jim O'Neill, Goldman Sachs, London

16:10 **Financial Stability**
Claudio Borio
Bank for International Settlements, Basel

16:30 Discussion

17:00 End of first day

19:00 Dinner
Dinner speech: **Dr. Alfred Tacke,**
State Secretary in the Federal Ministry of Economics and Labour, Berlin, and
Personal Representative of Chancellor Schröder for the preparation of the World Economic Summit

March 21, 2003

10:00 **Welcome and Introduction**
Hans-Günther Vieweg
Ifo Institute for Economic Research

10:10 **Prospects for the European Manufacturing Industries**
Moderator:
Peter Marsh
Financial Times, London

Steel Industry
Tony Cockerill
University of Durham

Chemicals
Ralf Gronych
BASF, Ludwigshafen

11:00 Coffee break

11:30 **Capital goods**
Dough Dunn
ASML, Veldhoven

ICT-Industry
Ulrich Hofmann
IBM, Paris

Automobiles
To be announced
HSBC, London

13:00 **Summary and Conclusion**
Hans-Günther Vieweg

13:30 Hot buffet lunch

14:30 End of conference