NEW MODES OF GOVERNANCE PROJECT

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# NEWGOV
# New Modes of Governance

Integrated Project
Priority 7 – Citizens and Governance in the Knowledge-based Society

## Workshop – Policy learning and experimentation in EU economic governance: Laboratory federalism in practice?

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| **Dissemination Level** | | |
| **PU** | Public | X |
| **PP** | Restricted to other programme participants (including the Commission Services) | |
| **RE** | Restricted to a group specified by the consortium (including the Commission Services) | |
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## Summary

Many of the new approaches to economic policy-making that have emerged in the EU in recent years are predicated on the idea that countries can learn from one another and can take advantage of experimental approaches tried out elsewhere to enhance their own policies. In the theory of fiscal federalism, the term laboratory federalism has been coined to describe how devolved policymaking leads to more innovation in governance. A laboratory federation contains the risks of policy experiments to a smaller part of the polity while the central level can provide the public good of disseminating the lessons from these experiments.

The workshop aimed to further our theoretical and empirical insight into the working of laboratory federalism in three policy areas that are of particular relevance to EU economic governance: policy coordination through social partnership, tax policy and macroeconomic stabilisation. We were looking for the various, perhaps hidden, channels through which the EU may shape and induce policy innovation as well as the obstacles it faces in acting as an effective or unbiased reform lever.

The answer that the workshop gave to this question was largely negative. EU membership and monetary union has led to some innovation in the role of social partnership, but this seems not to have had a lasting impact independent of the domestic setting.

The workshop took place at the European Institute, London School for Economics and Political Science, 30 – 31 March 2006.

## Contents

# I. Summary Report

Many of the new approaches to economic policy-making that have emerged in the EU in recent years are predicated on the idea that countries can learn from one another and can take advantage of experimental approaches tried out elsewhere to enhance their own policies. In the theory of fiscal federalism, the term *laboratory federalism* has been coined to describe how devolved policymaking leads to more innovation in governance. A laboratory federation contains the risks of policy experiments to a smaller part of the polity while the central level can provide the public good of disseminating the lessons from these experiments.

The workshop aimed to further our theoretical and empirical insight into the working of laboratory federalism in three policy areas that are of particular relevance to EU economic governance: policy coordination through social partnership, tax policy and macroeconomic stabilisation. We were looking for the various, perhaps hidden, channels through which the EU may shape and induce policy innovation as well as the obstacles it faces in acting as an effective or unbiased reform lever.

### 1. The role of social partnership in EU economic governance

The run-up to EMU led to an unexpected revival of social pacts. But a distinction has to be drawn between narrow/wide and symbolic/binding pacts, highlighting the fact that pacts may serve wider purposes than their traditional 'incomes policy' function of restraining inflationary expectations and speeding up the adjustment of wages to economic conditions (as understood in agreed models and forecasts). The discussion of the Irish and Slovenian social pacts suggested that the scope of social pacts was widening to take in new policy areas and reform issues, mostly on the supply side, but also in re-distribution through social policies. Along with this widening of scope, we also find a widening of participation: voluntary organisations and NGOs are increasingly involved in the process alongside the traditional 'social partner' membership. However, the degree to which employer interests are implicated varies according to issues.

There is no similar attempt at innovative institution building at the EU/ EMU level. The Macroeconomic Dialogue, which is the only EU institution that brings together social partners, the central bank, representatives of member states and the Commission, is at best a forum for the exchange of views between policymakers and the social partners, and occurs too infrequently to have much impact on policy-making. The impression conveyed was that the participants talk more 'at' each other than 'to' each other in a way that might make a difference to decisions. The social partners have not been able to make it an effective channel of communicating their views, partly because there are non-trivial differences of opinion between (and to some extent within) their representations at the EU level. National fiscal policy is not adequately represented at the discussions and in the case of both fiscal and wage policy there is too little articulation between the European and the national levels.

### 2. Tax policy coordination

A closer look at different taxes (direct and indirect) reveals that it is far from clear how much effective tax policy coordination there is in the EU. On the one hand, research finds very limited coordination in the area of corporate taxes, despite laborious attempts to implement traditional modes of governance (legal harmonisation, common standards etc). On the other hand, research finds that internal market requirements and the legal interpretation of non-discrimination create more pressures for tax harmonisation than meet the eye if one looks at EU directives and regulations only. These pressures arguably result in a lack of tax innovation and a preference for the same instruments, in particular in the area of indirect taxes.

The case studies of UK tax credits for low income households and of the Estonian flat rate tax reform provided contrasting examples of innovation in the realm of direct taxes, however. In both cases, domestic problems triggered reforms, namely the comparatively high poverty rate in the UK, and the challenges of reform and the need for a fresh approach to tax collection of a small open transition economy in Estonia. However, there is no sense in which the EU can be regarded as instrumental in shaping these reforms. UK policymakers studied similar schemes in other OECD countries (notably in Canada and Australia) in preparing their own reforms, while the Estonian government of the early 1990s largely depended on academic advice for the introduction of a flat rate income tax.

## 3. Macroeconomic stabilisation

In EMU, macroeconomic stabilisation is equated with fiscal consolidation and reforms that improve the adjustment capacity of member state economies on the supply side. Originally, this was based on the idea that a sound budget leaves enough room for automatic stabilisers as well as enough leeway to bear the upfront costs of structural reforms. The re-launch of the Lisbon Strategy as well as the reform of the Stability and Growth Pact suggest that these ambitions could not easily be attained. The changes introduced do not suggest a radical break with the philosophy that reform activism must not jeopardize fiscal prudence, since the burden of proof is on reformers. It is not clear yet how the two policy processes relate to each other as there are no instruments to make National Reform Programmes and Stability or Convergence Programmes consistent.

The assessment of how well fiscal authorities perform and comply with the stipulations of EMU membership seems to depend on the benchmark and the performance criterion. If compared with past performance as regards stabilisation, there seems to be overall an improvement of fiscal policies in terms of a more counter-cyclical (or less pro-cyclical) stance and adequate responsiveness, even if there are no mechanisms to ensure a stabilising fiscal policy for EMU as a whole. If compared with their plans for fiscal consolidation, governments show a serious implementation deficit, in particular as regards the envisaged expenditure-based consolidations. Compliance would apparently require reforms of domestic budgetary institutions, including ancillary bodies such as forecasting and statistical agencies.

The case studies of national stability pacts in Italy and Germany provided interesting contrasts. The Italian national stability pact was introduced as early as 1999. The central government has shifted responsibilities for deficit reduction to the regional and local level, but with limited success. The need for a pact seems to be the only constant in an endlessly shifting institutional setting. By contrast, it was the threat of an excessive deficit procedure in 2002 that provided the key impetus for the central government and the German Laender to find an agreement for a framework to restrain deficits overall. The central government and the Laender jointly take responsibility for containing public debt, yet the performance of Bund and Laender in this regard has been quite different. Especially the federal level has shown a persistent need for high net borrowing.

## II. Conclusions – Laboratory federalism in practice?

The answer that the workshop gave to this question was largely negative. EU membership and monetary union has led to some innovation in the role of social partnership, but this seems not to have had a lasting impact independent of the domestic setting. In tax policy, it is even conceivable that EU may hamper innovation. Finally, macroeconomic policy seems to struggle still with compliance, while EU constraints are not sufficiently binding to induce effective reforms of budgetary institutions.

Even the Lisbon strategy was found wanting in its contribution to laboratory federalism, even though it stresses the possibility of mutual learning within a common framework for policy, while leaving responsibility for implementation firmly with Member States. While the jury remains out on what is, after all, a new approach, it is far from clear that the substantial bureaucratic overheads it imposes will result in tangible gains. Moreover, the rationale for coordination at EU level of the policies under the 'Lisbon' umbrella is not all that clear, resulting more from the political economy of domestic reform politics than from spillovers that bear on, or are justified by, collective performance.

In spite of the limited evidence that EU circumstances offer support for the notion of laboratory federalism, the themes explored in the workshop raise a range of pertinent research questions for economic governance in today's EU. A first is whether there is a compelling case for coordinating reform efforts at the EU level. Empirical studies find that EU membership has a positive effect on reform activism, yet the direction of causation is far from clear. What governance framework would help member states with their domestic structural and budgetary reform agendas? More generally, how can EU/EMU economic governance be understood if neither the functionalist theory of fiscal federalism nor the concept of laboratory federalism applies? We found evidence for incentives and constraints at work that the principal-agent framework of public choice theory emphasizes (fiscal restraint due to competition and market discipline, common resource pool problems of asymmetric devolution etc). But how would the policy framework avoid the bias towards selective retrenchment and pro-cyclical policies that these forces create? What indeed does take care of the right policy mix for EMU? Is there any privileged role left for the traditional social partners if competition rather than cooperation, or policy rules rather than bargains, are meant to govern decision making in the EU? We plan to address these questions in future research.

## III. Final Programme

Thursday, 30 March in D306 (Clement House)

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| 9.30 | Arrival, coffee and tea |
| 10.00 – 10.15 | Welcome and introduction<br>Jelle Visser (Amsterdam), Waltraud Schelkle (LSE), Iain Begg (LSE) |

Chair: Iain Begg (LSE)

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| 10.15 – 11.30 | *Policy coordination and social partnership – in search of a role in EMU (1)*<br><br>Reform in wage-setting and labour market restructuring: what role for social partnership?<br>Jelle Visser (Amsterdam, EUI)<br><br>The Macroeconomic Dialogue: dialogue instead of action?<br>Gerhard Huemer (UEAPME)<br><br>The Macroeconomic Dialogue: all talk an no action?<br>Andrew Watt (ETUI) |
| 11.30 – 11.45 | Coffee break |
| 11.45 – 13.00 | *Policy coordination and social partnership - in search of a role in EMU (2)*<br><br>Social partnership in Ireland: what's left in EMU?<br>Rory O'Donnell (National Economic and Social Council)<br><br>Social partnership in Slovenia: how useful for EMU?<br>Tatjana Pajnkihar (Chamber of Commerce and Industry) |
| 13.00 – 14.30 | Lunch in the Staff Dining Room ($5^{th}$ floor of the Old Building) |

Chair: Waltraud Schelkle (LSE)

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| 14.30 – 15.30 | *Tax policy – governance, innovation and competition (1)*<br><br>How effective are new forms of governance in tax policy?<br>Ulrike Kraemer (Exeter)<br><br>Tax competition, tax harmonization and tax innovation<br>Philipp Genschel (IU Bremen) |
| 15.30 – 16.00 | Coffee break |
| 16.00 – 17.15 | *Tax policy – governance, innovation and competition (2)*<br><br>Tax credits for low-income households: how innovative, how transferable?<br>Ian Mulheirn (UK Treasury)<br><br>Flat rate taxes: how innovative, how transferable?<br>Mart Laar (MP and former Prime Minister of Estonia) |
| 17.15 – 18.00 | The Lisbon Strategy as policy co-ordination - does it promote policy learning?<br>Iain Begg (LSE) |

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| | The approach implicit in the re-launched Lisbon strategy to policy co-ordination<br>Joe Grice (ONS & Economic Policy Committee) |
| 19.00 | Dinner at Malabar Junction, 107 Great Russell Street (pass British Museum, between Bloomsbury Street and Tottenham Court Road) |

Friday, 31 March in D702 (Clement House)

Chair: Deborah Mabbett (Birkbeck)

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| 9.30 – 11.00 | *Macroeconomic stabilisation – the interplay between domestic institutions and the reformed Pact (1)* |
| | The new Pact: prioritizing structural reform over fiscal prudence?<br>Fabienne Ilzkovitz and Lucio Pench (DG Ecfin) |
| | Multilevel governance in fiscal consolidation and stabilisation: what are the incentives and the constraints?<br>Waltraud Schelkle (LSE) and Deborah Mabbett (Birkbeck) |
| | The interaction of national and supranational fiscal surveillance: how much reform is needed?<br>Peter Wierts (Dutch National Bank) |
| 11.00 – 11.30 | Coffee break |
| 11.30 – 13.00 | *Macroeconomic stabilisation – the interplay between domestic institutions and the reformed Pact (2)* |
| | The national stability pact in Italy: An Internal Instability Story<br>Fabrizio Ghisellini (Comune di Roma) |
| | The national stability pact in Italy<br>Chiara Goretti (Budget Service, Italian Parliament), Gelsomina Vigliotti (Italian Treasury) |
| | The national stability pact in Germany<br>William Brunton (Conference of the State Finance Ministers, Bundesrat), Martin Snelting (German Treasury) |
| 13.00 – 14.30 | Lunch in the Staff Dining Room (5th floor of the Old Building) |

## IV. List of Participants

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| Iain Begg | European Institute – London School of Economics and Political Science |
| William Brunton | German Bundesrat, Conference of the State Finance Ministers |
| Rory O'Donnell | Irish National Economic and Social Council |
| Philipp Genschel | International University Bremen |
| Fabrizio Ghibellini | Comune di Roma |
| Chiara Goretti | Italian Senate, Budget Service |
| Joe Grice | ONS, UK HM Treasury, and Chairman, EU Economic Policy Committee |
| Gerhard Huemer | UEAPME – European Association of Craft, Small and Medium-Sized Enterprises |
| Fabienne Ilzkovitz | European Commission, Directorate General Economic and Financial Affairs |
| Ulrike Kraemer | University of Exeter |
| Mart Laar | Estonian Member of Parliament and former Prime Minister of Estonia |
| Deborah Mabbett | Birkbeck College, London |
| Ian Mulheirn | UK HM Treasury |
| Tatjana Pajnkihar | Slovenian Chamber of Commerce and Industry |
| Lucio Pench | European Commission, Directorate General Economic and Financial Affairs |
| Waltraud Schelkle | European Institute – London School of Economics and Political Science |
| Martin Snelting | German Treasury |
| Gelsomina Vigliotti | Italian Treasury |
| Jelle Visser | University of Amsterdam |
| Andrew Watt | European Trade Union Institute |
| Peter Wierts | Dutch National Bank, University of Reading |

The workshop was also attended by graduate students from the European Institute of the LSE.