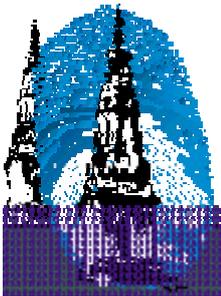


LEFIC

Copenhagen Business School
Solbjerg Plads 3
DK-2000 Frederiksberg



**Center for Law, Economics
and Financial Institutions at CBS**

LEFIC WORKING PAPER 2003-11

**Creeping Federalization: Limits on Economic Harmonization in
The United States and The European Union**

Richard J. Sweeney

www.cbs.dk/LEFIC

Creeping Federalization: Limits on Economic Harmonization in The United States and The European Union

Richard J. Sweeney *

McDonough School of Business
Georgetown University
37th and "O" Streets, NW
Washington, DC 20057
(O) 1-202-687-3742
fax 1-202-687-7639, - 4130
email sweeneyr@georgetown.edu

Abstract: The U.S. Constitution importantly limits the degree to which the federal government can impose harmonization across member states. This paper reviews these limitations and how they have evolved substantially over time in the U.S. It also discusses some of the benefits and costs of such limitations, and argues that the EU may benefit from adopting similar limitations. Harmonization of EU tax codes is likely to be economically harmful. On theoretical grounds, tax rates are likely to be harmonized at a common rate that is higher than optimal for the EU. This suggests the benefits of constitutional provisions that make tax harmonization difficult to impose. Other types of harmonization have a less clear-cut cost-benefit analysis. A federal commercial code that is uniform across member states reduces transaction and information costs, compared to leaving important code issues to member states; further, many states may keep codes for long periods that are sub-optimal compared to a given federal code. A federal code may, however, fit poorly with other institutions of member states, potentially causing large costs. Leaving codes to the states leads to competition across states, and may generate forces for change for the better. Competition also generates information about the effectiveness and costs of different commercial codes. Because any country's initial code is likely to be sub-optimal, and is likely to become less optimal over time, information on how to improve codes is valuable. Likely it is easier to learn and adapt from member states than from other countries.

* For helpful comments, thanks are due to Clas Wihlborg and Subashis Gangopadhyay, and participants in a joint workshop of LEFIC and the Law School at the Copenhagen Business School. Parts of this paper were presented at the Mölle Conference; the author is grateful for comments to Evald Nalin and other participants in a plenary session. Parts of this paper were written at the Copenhagen Business School, and at the Gothenburg School of Economics.

Creeping Federalization: Limits on Economic Harmonization in The United States and The European Union

Abstract: The U.S. Constitution puts important limits on the degree to which the federal government can impose harmonization across member states. This paper discusses some of the benefits and costs of such limitations, and argues that the EU may benefit from adopting similar limitations. Harmonization of EU tax codes is likely to be economically harmful. On theoretical grounds, tax rates are likely to be harmonized at a common rate that is higher than optimal for the EU. This suggests the benefits of constitutional provisions that make tax harmonization difficult to impose. Other types of harmonization have a less clear-cut cost-benefit analysis. A federal commercial code that is uniform across member states reduces transaction and information costs, compared to leaving important code issues to member states; further, many states may keep codes for long periods that are sub-optimal compared to a given federal code. A federal code may, however, fit poorly with other institutions of member states, potentially causing large costs. Leaving codes to the states leads to competition across states, and may generate forces for change for the better. Competition also generates information about the effectiveness and costs of different commercial codes. Because any country's initial code is likely to be sub-optimal, and is likely to become less optimal over time, information on how to improve codes is valuable. Likely it is easier to learn and adapt from member states than from other countries.

Creeping Federalization: Limits on Economic Harmonization in The United States and The European Union

1. Introduction

The extent of power accumulated at the federal level in the U.S. has risen substantially since the 1930s, and continues to rise. As for the European Union, “an ever closer union” is an explicit goal, and power has risen sharply at the Union level since the days of the European Coal and Steel Community. These trends towards federalizing power in the EU and the U.S. raise the questions of how much power, and which powers, are best allocated to the federal government, and which left with the member states. The U.S. Constitution contains specific, limited, enumerated powers allocated to the federal government, designed to limit federal accumulation of power. This paper reviews a number of episodes and trends in U.S. history to assess the costs and benefits of imposing such limits on EU institutions in a new EU constitution, especially in light of federal accumulation of power since the 1930s.

Harmonization is a major concern in the EU. For example, there is considerable effort being made in the EU to increase harmonization of tax policies across member states, and to a lesser extent to impose harmonization of expenditures policies. Various aspects of EU member-states’ commercial codes have already been harmonized, and the desirability of substantially more harmonization is being raised in discussion. In imposing harmonization, the EU is not as clearly constrained by constitutional limits as the U.S. federal government.

The EU is considering a constitution. A major issue is what limitations it might be prudent to put on the powers of the EU to compel these various types of harmonization across member states. This paper briefly examines the evolution of federalization in the U.S., and the pros and cons of U.S. harmonization in a number of cases. On the basis of this discussion, the paper raises doubts about the wisdom of harmonization across member states that is imposed

by the EU, and thus makes the case for constitutional restrictions on this type of creeping federalization. To be sure, in some of areas of harmonization, costs and benefits are relatively low, or at least the net costs are relatively low; thus, the decision on harmonization is not crucial to the economic health, let alone the survival of the EU as a whole. One example, perhaps, is harmonization of commercial codes. Other areas of harmonization, for example, tax codes and more particularly harmonization of tax rates across member states, may have substantial negative net economic effects. Over time, the negative effects from misguided harmonization may be severe enough cumulatively to lead to serious political strife that could threaten the EU. One way to analyze the break up of the U.S. in 1860-1861, and the following Civil War, is in terms of perceived threats from federal government power and member-state reactions to them.

At various points, the paper compares harmonization in the EU with harmonization in the U.S. The federal nature of the U.S. system sees to it that there is often incomplete harmonization. This does not mean that the U.S. approach is correct. Rather, the U.S. provides a concrete base case for use in considering limitations that the EU may find it prudent to put limitations on its own powers to compel harmonization. Further, both the EU and the U.S. are federations, in the sense that some but not all sovereign power is at the federal level, and some sovereign power is at the level of member states. It is valuable to look at another major federation in considering a constitution for the EU. A substantial part of the U.S. history discussed in this paper is from the eighteenth and nineteenth centuries. On the one hand, this reduces the relevance to twenty-first century issues. On the other hand, during this period the U.S. was developing federal institutions just as the EU is now.

2. Growth of Harmonization in the U.S. and the EU

The U.S. Constitution limits the powers of the federal government, but as noted above these powers have nevertheless grown substantially since the 1930s. This growth arises

for four reasons. One method for creeping federalization is that the federal constitution trumps member-state laws, or is the supreme law.¹ In areas where the U.S. Constitution gives the federal government the right to act, for example, regarding international commerce or bankruptcy, differences in state laws are pre-empted. As the federal government introduces more laws, regulations, etc., in its sphere of supremacy, it creates more homogeneity. EU treaties similarly trump member-state laws; through mechanisms similar to the U.S.'s, the sphere of EU standards expands over time.

A second mechanism is federal pressure for harmonization of economic laws, rules and regulations across member states. Harmonization is popular and many view it as a good thing in both the U.S. and the EU, though it appears more popular in the EU than the U.S. Harmonization is restrained in the U.S. by the requirement that the federal government has to show that its actions are constitutionally justified by its powers either under the Interstate Commerce Clause or the Necessary and Proper Clause, or under its powers “to promote the general welfare.”² For example, one of the main goals of the supporters of a new U.S. constitution in 1787 was to form a customs union. In their view, interstate trade policy had to be removed from the hands of the separate states and lodged with the federal government, and the federal government should adopt uniform trade policies for all states (Madison 1920, Bowen 1966, Miller 1992, Berkin 2002). From this viewpoint, the Interstate Commerce

¹ *Constitution of the United States*: Article 6, Section 2: “This constitution, and the laws of the United States which shall be made in pursuance thereof; and all treaties made, or which shall be made, under the authority of the United States shall be the supreme law of the land; and the judges in every state shall be bound thereby, any thing in the constitution or laws of any state to the contrary notwithstanding.”

² *Constitution of the United States*: Article 1, Section 8: “The Congress shall have the power 1. To lay and collect taxes, duties, imposts and excises, to pay the debts and provide for the common defence and general welfare of the United States...”

During the Civil War, the framers on the Confederate Constitution closely followed the U.S. Constitution, but altered it where it bore on Southern grievances against the federal government. To be sure, a major purpose of the Confederate constitution is to explicitly permit and defend slavery. Its writers, however, had additional ideological purposes. Because they thought the U.S. Constitution’s clause to “promote the general welfare” was so broad that the federal government had used it to abuse the states’ rights, they omitted this clause from their constitution. For similar reasons, they omitted the clause “to provide for the common defense.”

Clause³ is designed to prevent states from putting restrictions on interstate commerce. On the one hand, the clause gives powers to the federal government to regulate interstate commerce; on the other hand, the federal government is restricted to at least some extent.⁴ Restrictions on how far the federal government can go in imposing harmonization under the Interstate Commerce Clause have weakened greatly since the early 1900s, especially since the 1930s.

From the point of view of the mid-1940s, Vreeland (1944) pp. 14-15) writes:

[A]mong the powers expressly delegated to the United States was not police power. That is a technical phrase. It has nothing to do with brass button and a night stick. It is the power of a state to act in the interest of public health and morals and safety.... [T]he United States has built its *police power* as a “*necessary and proper*” power to make effective its powers, which were expressly granted. For many years the Supreme Court never admitted that it was constructing such a power but recently it has conceded with commendable frankness that it has done so. Almost all of this Federal police power in time of peace rests upon the expressly granted power to *regulate interstate commerce*. [Italics added.]

The Necessary and Proper Clause⁵ is the device that expands the limited, enumerated powers that are all the constitution grants the federal government. Attempts to include in the Constitution or Bill of Rights the restriction that the federal government had only the explicit enumerated powers were beaten back (McDonald 2000, Miller 1992). Instead, the federal government had these enumerated powers, ***and*** any other powers that were ***necessary and proper*** to exercise the enumerated powers, provided only that these unenumerated powers are not explicitly denied to the federal government or reserved to the states or people.⁶ Based on the Interstate Commerce Clause, the federal government imposed federal minimum wage laws across the states, imposed federal food and drug regulations, and

³ *Constitution of the United States*, Article 1, Section 8. “The Congress shall have the Power ... To regulate Commerce with foreign Nations, and among the several States, and with the Indian Tribes.”

⁴ Starting in the 1930s, a series of Supreme Court cases discuss direct effects on interstate trade, indirect effects, and whether the effects are substantial, with the federal government acquiring increasingly broad scope to regulate. For a skeptical discussion in the midst of this expansion, see Vreeland (1944). Beginning in the 1990s, the Supreme Court has fixed at least modest restrictions on federal power under the Interstate Commerce clause.

⁵ *Constitution of the United States*, Article 1, Section 8. “The Congress shall have the Power ... To make all Laws which shall be *necessary and proper* for carrying into Execution the foregoing Powers, and all other Powers vested by this Constitution in the Government of the United States, or in any Department or Officer thereof.” (italics added.)

regulated hours and working conditions in the states to a large extent, among other things; the Supreme Court upheld the constitutionality of these laws as necessary and proper exercises of powers the Constitution grants the federal government.

As noted above, “police powers” is a technical term that refers to the traditional Anglo-American legal and regulatory categories of property relations, family relations, education, religion, public health, public safety, public morals and crime. The EU has supreme power in some parts of the police powers in EU countries. All members of the EU have ratified the Maastricht Treaty, and have also adopted the European Charter of Human Rights as part of their constitutional law. The Social Chapter of the Maastricht Treaty, and the European Charter of Human Rights, allow for EU regulation of working hours and conditions, social policies regarding prostitution and homosexuality, etc. The European Commission does some of the regulation under police power, and the European Court of Justice has a major role in interpreting what the guaranteed rights mean in practice. Thus, both the EU and the U.S. federal government started out with very little police power, but both have accumulated large amounts over time, for example, over wages, working hours and working conditions. Both have some, though limited, power over education across member states. The EU probably has less power over crime and some aspects of public safety than does the federal government. In both the EU and the U.S., most police officers are under member-state control, though law enforcement is substantially more centralized in the average EU member state than in the average U.S. state.

The EU also has supreme power in some areas because of single-market powers in the Maastricht treaty. The EU can impose some harmonization of manufacturing standards, and can regulate many arrangements for selling and buying, and impose many quality standards.

⁶ Some argue that the U.S. Constitution is designed in effect to foster capitalism. For the debate, see Goldwin and Schambra, eds. (1982). In particular, McDonald (1982) argues that the Constitution was far from designed to

Police powers are inherently subject to expansion, allowing both widening and deepening of harmonization. U.S. attempts to place restraints on federal harmonization of police powers have been increasingly ineffective since the 1930s. EU attempts under the principle of “subsidiarity” have less constitutional standing and have been even less effective. In the absence of amendments to the U.S. Constitution, the Supreme Court has the only substantial, effective power to prevent harmonization across states that the executive or legislative branches desire. As seen above, the Supreme Court has been quite accommodating to expansion of federally imposed harmonization since the 1930s. In the 1990s, however, the Court has placed some restrictions on federal powers. It is not clear how extensively the Court might restrict federal power in the future; the Constitution’s explicit limitations on federal power, however, gives the Court substantial scope to act if it wants to. In the EU, it appears that there are relatively few constitutional statements that explicitly limit the scope of federal powers over harmonization. Thus, there is scope for imposing constitutional limits on the ability of EU institutions to impose harmonization. U.S. history suggests that later judicial interpretation in the EU may be able to get around constitutional restrictions, even carefully drawn restrictions, but these appear to be the only barrier. European Court of Justice decisions have often taken an expansive view of EU powers to impose harmonization.

A third, related mechanism is that the Constitution’s Fourteenth Amendment grants citizens the same rights and protections against state government as the Constitution grants against the federal government, or rather this is the Supreme Court’s firm view since the 1950s, after previously holding the opposite. For example, the federal government sets the limits on religious expression in public schools that states may permit, under the power of enforcing the First Amendment guarantees regarding freedom of religion⁷. Federal law has thus become supreme over state law in the wide range of areas covered by the federal Bill of

foster capitalism.

Rights. Further, under the Fourteenth Amendment’s “due process” and “equal protection” clauses, the Supreme Court has final say on whether a state’s law treats its citizens in a constitutional way⁸, and thus has great influence on state laws and practices.⁹ The European Court of Justice similarly has final say on a range of issues covered by EU treaties, including the social chapter in the Maastricht Treaty and the European Convention on Human Rights; this is analogous to the federal government to decide what member states must do to be consistent with U.S. Bill of Rights.

Fourth, a major increase in the federal government’s power to impose harmonization across the states came from the Sixteenth Amendment (ratified February 3, 1913), which allows Congress to impose income taxes. Before, the federal government was severely limited in the amount of revenue it could raise—tariffs were a major source of revenues. In the period after the Second World War, the federal government introduced many programs that offered the states federal funds, but only on condition that the states adopt federal standards in areas related to the programs (and sometimes only distantly related to the programs, some argue). For example, for some years, the federal government threatened to withhold highway funds from states that did not impose a maximum speed limit of 55 miles per hour. In addition, the federal income tax code contains a wide variety of incentives and disincentives designed to affect individuals’ behavior. Of course, the federal government would not have the revenues to exercise this great amount of leverage in the absence of the power to impose income taxes.

⁷ *Constitution of the United States*: First Amendment, “Congress shall make no law respecting an establishment of religion, or prohibiting the free exercise thereof; ...”

⁸ *Constitution of the United States*: Fourteenth Amendment, Section 1, “... No State shall make or enforce any law which shall abridge the privileges or immunities of citizens of the United States; nor shall any State deprive any person of life, liberty, or property, without *due process of law*; nor deny to any person within its jurisdiction the *equal protection of the laws*....” (italics added.)

⁹ From the point of view of the mid-1940s, Vreeland (1944, p. 15):

[L]imiting governmental powers in favor of persons are two general and non-particularized constitutional provisions known as the “due process” and “equal protection” clauses.... The due process clause of the Fifth Amendment limits Federal action.... In the Fourteenth Amendment there are both due process and equal protection clauses, each limiting State power in favor of persons. Since then, the Fourteenth Amendment has been used to substitute federal for state control over the “police power.” See above.

One measure of federal influence on the U.S. is the number of federal government employees and their distribution across jobs and geographically. In the early days of the U.S., the federal government was quite small, and many people had little contact with federal employees, beyond postal employees. Fleming (1999, p. 103) writes:¹⁰

The federal government was a puny affair in 1804. Excluding 6,479 sailors, soldiers, and marines, it numbered only 2,267 employees. Most of these worked as postmasters and collectors of customs in distant cities and towns. Congress, the Supreme Court, the president and his cabinet, and their employees numbered only 293 people. When this tiny band migrated to the Federal District in 1800, they virtually vanished from the national consciousness.

Note that the U.S. population in 1790 census was approximately 4 million. Over time, federal employment has grown strikingly. For comparison, consider Table 1, which incorporates the numbers from Fleming (1999). U.S. government civilian employment trended modestly upward during the nineteenth century, but the comparison with 1970 is startling. Of course, the expansion in federal revenues after the income tax was instituted financed much of the growth in federal employment after the Second World War. At the start of the Civil War in 1861, for example, Table 1 implies that out of every 100,000 Americans a person might meet outside of Washington, DC, only 11 on average would be federal employees, and of these 88% would be postal employees. By 1970, out of every 100,000 Americans a person might meet outside of Washington, DC, 130 on average would be federal employees, and of these only 28% would be postal employees. The average American deals a great more with the federal government than in the nineteenth century. To the extent dealing with federal employees reduces the average citizen's regard for the federal government, the trends in employment put strains on the federal system. If the EU's revenues are expanded by the ability to levy taxes, surely some will go to increase the number of EU employees, and thus the contact of the average EU citizens with EU employees.

¹⁰ Fleming's notes refer to Friedenber, Daniel M., *Life, Liberty and the Pursuit of Land*. Buffalo, NY, 1992, p. 345.

Aside from the EU's lack of authority to impose income taxes, federalization in the EU has been subject to many fewer constitutional limitations than in the U.S. The ambience of federalization in the EU is captured, perhaps, by some quotes.

A senior German diplomat [argues] that the big decisions in the European Union have always been made by elites, and have then gained popular acceptance later. "If we had had a referendum on the treaty of Rome, people might have rejected it on the grounds that it raised the price of bananas." (*Economist*, Oct. 5, 2002, p. 36.)

Jean-Claude Juncker, Luxembourg's prime minister, once described the E.U.'s 'system.' "We decide on something, leave it lying around and wait and see what happens," he explained. "If no one kicks up a fuss, because most people don't understand what has been decided, we continue step by step until there is no turning back." (*Economist*, Sept. 14, 2002, p. 33.)

Many Europeans are sceptical of this approach, and would like to have EU powers more clearly defined and limited. An example, perhaps, is

The [EU] constitution should start with just a few lines, setting out what the EU is—a union of sovereign states who have decided to pool some of that sovereignty, better to secure peace and prosperity in Europe and the wider world. It should confirm that the Union exercises only those powers that are explicitly and freely conferred on it by the member states, which remain the EU's primary source of democratic legitimacy. (Jack Straw, "A constitution for Europe," *Economist*, Oct. 12, 2002, pp. 41- 42.)

3. Costs and Benefits from Federal Harmonization

In a federal system, many federal decisions—executive orders, legislation, court decisions, etc.—fundamentally involve harmonization of laws across member states. The federal government may make new law that applies to all member states, with the new law *ipso facto* harmonized across states. Or the federal government may address issues already subject to member-state laws, and in doing so force partial or complete harmonization of laws across member states—provided federal constitution and laws etc., are supreme over the states in the particular area, or the federal government can use fiscal incentives, etc.

In both the U.S. and the EU, member states often oppose a given instance of economic harmonization. For example, opposition is likely to occur if harmonization removes a competitive advantage or creates a competitive disadvantage for a subset of member states. A

well-known example for the EU is harmonization of bank secrecy laws. Another example is the struggle in the EU over harmonization of tax policies. To the extent that the results of a particular harmonization are a zero-sum game across EU member states, the average state can hope to break even on progressive harmonization—but at the risk of suffering on net, either through chance or because of the lack of political power to block harmonization that severely harms the member state.¹¹ In such cases, the risk of loss dominates the zero expected gain, because of risk aversion. As for the EU compared to the rest of the world, harmonization may work to remove a competitive advantage or to create a competitive disadvantage for the average member state and the EU as a whole—in such a case, the average member state loses, as does the EU as a whole. An example is tax harmonization *if* it is at such high rates that the EU is at an increased disadvantage relative to the U.S., Japan or the rest of the world.

The Race to the Bottom. In discussions in the EU, as in the U.S., economic harmonization across member states is frequently contrasted with a “race to the bottom,” in which some states gain an advantage over other member states by adopting economic laws or regulations that are less stringent than the average across the federation. It is sometimes argued that in the limit, the race to bottom can lead all member states to adopt the laws and regulations of the least stringent member state, or that many businesses will arrange matters so that, wherever they operate, the least stringent code applies. An example sometimes offered is the fact that a large percentage of major American firms are incorporated in Delaware, where laws are seen as more favorable to corporations than in other states; other states need not adopt a code as relaxed as Delaware’s, but few corporations will be headquartered in them. To the extent this happens, “the race to the bottom” can be viewed as a

¹¹ To be sure, federal harmonization is likely to have differential effects on the citizens within a given member state, some losing, some gaining. If the gainers have sufficient power, the member state may support the harmonization, though the population as a whole loses. Taking account of such complications does not change the major points in this paper, and hence such complications are not explicitly discussed below.

mechanism towards harmonization of standards, but at less stringent levels than those supported by advocates of imposing federal harmonization.

In principle, harmonization might be aimed at adopting federal standards that are less, rather than more, stringent than most member states have. In practice, harmonization is most often proposed at levels that compel some member states to adopt harsher laws; indeed, that often seems the purpose of harmonization. The regular contrast between harmonization and “the race to the bottom” reveals how efforts at harmonization are frequently aimed at imposing more stringent federal standards than some member states currently use.

Harmonization of tax rates at a high level in the EU, for example, may benefit those member states with high tax rates, to the disadvantage of those with low taxes, in inter-EU competition. Harmonization also has effects on the EU vis-à-vis other countries or the rest of the world. If EU taxes are harmonized at a level that is notably severe relative to the U.S., Japan and other international competitors, the EU as a whole may be harmed, even if some high-tax EU states gain on net from facing less competition from other EU states that would otherwise have lower tax rates.

Efficiency, Redistribution and Side Effects. Any particular instance of harmonization is generally supported by the argument that it will lead to greater efficiency, and make the federation as whole better off. In the cases discussed above, however, a major effect of harmonization is redistribution among member states. This suggests a skeptical attitude towards claims of increased efficiency from harmonization. In particular, if a given instance of harmonization is supported as the alternative to a “race to the bottom,” perhaps the presumption ought to be that the major effects are on distribution, not efficiency, and that claims of enhanced efficiency should be documented with substantial evidence before being accepted.

Sometimes harmonization involves only one part of an interrelated set of issues. In such a case, harmonization implicitly requires many other adjustments in a given country's laws if harmonization is to work well; if the other, interrelated laws are not adjusted, or are adjusted poorly, harmonization may injure the member state. An example discussed below is harmonization of commercial codes across member states in a federation. In the U.S., there is only partial harmonization of commercial codes across the states (similarly, there is only partial harmonization of other types of regulations on economic activity). In harmonizing over only one set of issues, the danger is that the overall web of regulations and institutions for a given member state is moved farther from rather than closer to optimality. As seen below, given the costs of adjusting other laws and institutions, and the lags in doing so, commercial code harmonization with positive gross benefits may impose such substantial costs that the result is negative net benefits.

Harmful Effects of Harmonization, and The Reservoir of Goodwill. Thus far, two types of harmonization may harm the average member state: (a) harmonization aimed at redistribution that does not help or actually harms the average member state, and (b) harmonization with positive gross benefits but negative net benefits. Repeated experience of these two types of costly harmonization can easily drain the reservoir of goodwill of the member states towards the federal government. Member states are not stupid, they often resist harmonization that hurts them for others' gains, and are embittered when they lose these struggles. Goodwill is a vital ingredient in making any federal system work well. To be concrete, think of goodwill as the pre-disposition of member states to believe that federal decisions in general work to help the average member state, and that over time and over many decisions, harmonization is likely to make each member state better off. In every instance of proposed harmonization, there are always pros and cons, the balance between the pros and cons is often unclear, and often there are some member states that lose while others gain. In

the absence of goodwill—a presumption in favor of federal harmonization when it is proposed—harmonization may face great difficulty in gaining the assent of the member states. If the federal government spends its store of goodwill on dubious measures of harmonization, member states may later refuse to accept particular measures that are in fact beneficial. Or, if the member states cannot resist federal measures for harmonization, hostility towards the federal government is likely to grow. The more member states believe “the system works,” the more likely they are to let the federal system work. And the more member states believe “the system does not work,” the harder is it for the federal system to work.

Examples from U.S. History: Loss of Goodwill Towards Federal Government. U.S. history provides a number of important examples about how the loss of goodwill in a federal system can harm the system and even put it in danger of falling apart. In the eighteenth and nineteenth centuries, one region in the U.S. and then another came to feel that it was systematically treated badly by the federal government, and that the region could do little politically to protect itself from the federal government. One case was New England from say 1803 to the 1820s. During this period, the Democratic Republican party, initially organized by Thomas Jefferson and James Madison, dominated the federal government and many states, and it appeared that the opposition Federalists, centered in New England, were permanently cut off from power. New England Federalists were hostile to President Thomas Jefferson’s Louisiana Purchase of 1803, because they thought the huge territory would eventually be split into states that would be aligned against New England’s interests, putting New England in a permanent minority. In 1807-1809, at the height of the Napoleonic wars, President Jefferson imposed an embargo on all trade, and progressively tightened the embargo and the penalties for violating it. The purpose of the embargo was to avoid becoming entangled in the wars between Britain and her allies on one side against France on the other side. The result was gravely to harm shipping and trade, on which New England depended extensively. In 1812, at

the request of President James Madison, Congress declared war on Britain, but virtually no member of Congress from north of Pennsylvania voted for the war, which lasted until 1815. The war severely harmed New England commercial interests. Many New England Federalists reacted by talking of interposition, nullification and even secession (Adams 1905, Banner 1970).

By 1820, conflicts over slavery and other issues convinced many in the South that they were being treated badly by the Union. In the South, opinions on slavery changed from viewing it as a necessary evil, when the Constitution was ratified in 1787-1990, to considering it as a positive benefit to the slave and master (McPherson 1988). Further, Southern opinion evolved from favoring or acquiescing in restricting slavery to where it existed, to demanding that slavery's expansion in the territories be allowed and even assisted by the federal government. At the same time, opposition to the expansion of slavery on moral grounds grew in the North and Mid-West. Further, from very low levels in 1820, sentiment for complete abolition of slavery grew in the North.

The South had other complaints about treatment by the federal government. A key complaint was the adoption of protective tariffs that favored Northern manufacturers at the expense of Southern agricultural producers. In response, the South developed the doctrine of Nullification. Some in the South complained that federal revenues were not fairly allocated to public works in their area (the fights over "internal improvements").¹² In the 1840s, conflicts over tariffs were settled by agreement on a lower tariff that was not heavily geared toward

¹² The Constitution permits the federal government to impose and collect taxes only "to pay the Debts and provide for the common Defense and general welfare of the United States." McDonald (1985, pp. 264-265) writes:

The phraseology was derived from the language of the Articles of Confederation and was understood as prohibiting the expenditure of money for such "internal improvements" as roads and canals, since those must of necessity, promote the particular welfare of specific states rather than the "general" welfare.... Hamilton, an advocate of "loose construction" though he was, thought that Congress could not authorize the building of such internal improvements as canals, and he proposed a constitutional amendment granting such power.

protection, and by the early 1850s, the federal government was providing large subsidies, through land grants, for railroads, the major internal improvement then being discussed.

By the 1850s, though the problems of the tariff and internal improvements were basically solved, many in the South had hostile feelings towards the North, as did many in the North towards the South. On the one hand, many in the South felt that the other regions were out to establish permanent dominance over the South, with the goal of eventually destroying slavery and Southern society. On the other hand, many in the North felt there existed a “slave power” that dominated the federal government, that the “slaveocracy” dominated the country. Representatives and senators across the regions found it increasingly difficult to co-operate or trust each other; shouts, threats and fistfights sometimes occurred, and some members began to carry weapons on the floors of Congress. There seemed little goodwill left for finding a solution. Eventually, these tensions resulted in Southern-state secession and the Civil War; over 600,000 men lost their lives in the war.

When Federal Harmonization Helps. To be sure, in some cases, harmonization can in principle benefit the average member state. First, the member states may be in a type of prisoners’ dilemma. Each state knows that if all shift to say a new, harmonized commercial code, all will be better off. But if one state shifts and the others do not, that state loses and the others gain. Federal decision makers may then impose harmonization that all agree is beneficial but would be otherwise hard to achieve.

An example from U.S. history is the harmonization across states of internal tariffs at zero. Economic theory suggests that the states were better off on average from this harmonization, but history suggests that it was very difficult for any one state to adopt a permanent zero-tariff strategy against other states that pursued active protectionist policies.

Second, a member state may have a dysfunctional government that finds it difficult to adopt policies that are favored by and beneficial to a substantial majority of the state’s

citizens. An example is systemic corruption with which the state has been unable to deal. Harmonization may aid the state in fighting corruption by imposing federal standards that the state would be unable to pass or to police for itself. If the harmonization helps the dysfunctional state and harms none of the others, all is well. But the types of laws that help a dysfunctional state may be sub-optimal for better-run states, and these better-run states may feel badly used. On the one hand, some EU member states—some observers suggest, for example, Italy or some of the central European candidate states—may expect federal decisions to be less corrupt than those taken at the national level. On the other hand, EU member states such as the Nordic countries may have more faith in the probity of their national governments rather than in the probity of EU decision makers. Raising decisions to the federal level may result in less corruption on average for member states, but in more corruption for those states that have low corruption to start with. These less corrupt states may then view the EU as having a bias towards federal decisions that harm them.

Delegates to the U.S. Constitutional Convention in 1787 were well aware of the poor quality of government that existed in some of the thirteen states. Rhode Island, often referred to as Rogues' Island, was notorious and was not interested in reform—it refused to send delegates to the Convention (Bowen 1966, McDonald 1985, Miller 1992, Berkin 2002). Observers charged that its legislature was corrupt, that it ran inflationary monetary policies, that it abused its legal-tender power, and that it discriminated against creditors from other states. Some feared that poorly run states would degenerate into some non-republican form of government. A number of proposals at the Convention were designed to deal with problems of unsatisfactory state governance. Perhaps the principle proposal, which James Madison strongly pushed, was to give the Federal legislature a veto (or a “negative” as they called it) over any state law (Madison 1920, Bowen 1966, Miller 1992, Berkin 2002). Madison pushed for such a negative on many occasions, but never got majority support. In a sense, under

current Supreme Court interpretation of the Fourteenth Amendment to the U.S. Constitution, the federal judiciary has acquired a veto over state laws that are judged inconsistent with the rights guaranteed by the U.S. constitution.¹³ Before the Fourteenth Amendment, the individual states could make some laws that it would be unconstitutional for the U.S. Congress to make. An example is an established church. The First Amendment forbids the Federal government to establish any religion; individual states, however, could and did have established churches. In 1833, the Supreme Court ruled that the Bill of Rights “applied only to the national federal government, not to the states.” Smith (1996, p. 520.) By the mid-twentieth century, however, the U.S. Supreme Court had adopted the view that, under the Fourteenth Amendment, the states must respect the rights that were guaranteed by the Constitution at the federal level; if Congress could not violate a particular right, neither could state legislatures.

Other restraints on unsatisfactory state governance were adopted, primarily by moving specified powers from the state to the federal level.¹⁴ The Constitution does not allow states to issue their own money¹⁵, and or to decide on legal tender¹⁶. The Constitution gives Congress the right to draw up a national bankruptcy code¹⁷. The Constitution guarantees that each state will have a republican form of government.¹⁸ The Federal government may also use force to suppress rebellions within a state.¹⁹

¹³ See a footnote above for Section 1 of the Fourteenth Amendment.

¹⁴ Farrand (1937, Vols. 1 - 4) offers a compilation of records of the convention, and some later documents that bear on Convention issues. For notes by members of the Convention, see Hamilton (VA), Madison (VA), King (MA), McHenry (MD), Lansing (NY), Paterson (NJ), Pierce (GA) and Yates (NY). Bowen (1966) provides a narrative of the Convention, and Berkin (2002) provides a more abbreviated narrative. Berkin provides brief biographies of the framers, and NARA (National Archives and Records Administration), Constitution web page, provides longer biographies of the fifty-five Framers. See also Miller (1992) and McDonald (1979, 1985).

¹⁵ *Constitution of the United States*, Article 1, Section 9: “No State shall ... coin money ...”

¹⁶ *Constitution of the United States*, Article 1, Section 9: “No State shall ... make any Thing but gold and silver Coin a Tender in Payment of Debts ...”

¹⁷ *Constitution of the United States*, Article 1, Section 8: “The Congress shall have Power ... To establish ... uniform Laws on the subject of Bankruptcy throughout the United States ...”

¹⁸ *Constitution of the United States*, Article 4, Section 4: “The United States shall guarantee to every state in this Union a Republican form of government, and shall protect each of them against Invasion, and on Application of the Legislature against domestic Violence.”

¹⁹ *Constitution of the United States*, Article 1, Section 8: “The Congress shall have Power ... To provide for calling forth the Militia to ... suppress Insurrections and repel Invasions.” See also a footnote above on Article 4, Section 4.

If federal decision makers aim at harmonization that solves prisoners' dilemma situations, then federal harmonization is likely to increase goodwill towards the federal government. If federal decision makers aim at harmonization that helps dysfunctional states, but is carefully designed to leave unharmed well-functioning states, again federal activity is likely to increase goodwill towards the federal government. To the extent that the federal government is chary about forcing harmonization that would not help the average state, or would actually harm the average state, and is seen to be chary about this, in the aggregate federal harmonization raises the reservoir of goodwill. As discussed in the next section, decision makers are apt to ignore the overall health of the system and thus to push for harmonization that harms the system as a whole.

Until the 1950s, the Supreme Court dealt with cases involving the states primarily under three heads. One was conflicts involving interstate trade. Another was suits by one state against other states. A third was suits by citizens against states. These heads led to a number of important Supreme Court decisions that gave important structure to economic laws and regulations. In particular, as seen above, the Supreme Court started in the 1930s to interpret the Interstate Commerce clause in such an expansive manner that the federal government accumulated substantial police powers. This empowered the federal government to impose over time a good deal of harmonization in a wide variety of areas, through laws passed by Congress, through regulations imposed by the executive branch, and through lower court decisions that followed the law as interpreted by the Supreme Court. These efforts at harmonization were not systematic, but were mainly small steps that added up. In addition, starting in the 1950s, the Supreme Court has intervened extensively under the Fourteenth Amendment, and under the right to privacy that the Supreme Court finds is implied by "penumbras" formed by "emanations" from the First, Fourth, Fifth and Ninth Amendment to

the Constitution.^{20, 21} These decisions have moved even more police powers to the federal level and out of the hands of the states. Thus, piecemeal over the past seventy years, federal laws, executive orders and court decisions have imposed a great deal of harmonization across the states. In each instance of harmonization, however, the federal decision makers involved seldom had any incentive to consider the cumulative effects of harmonization on goodwill towards the federal government. As discussed below, because federal bureaucrats do not consider the effects of their decisions on goodwill in exercising police powers, their decisions create externalities.

4. Damage from Federal Tax Harmonization

One of the major purposes of replacing the Articles of Confederation with the U.S. Constitution was to solve the problem of the individual states running their own trade policies, including protectionism aimed at the other states and retaliation for such protection. The Constitution in effect made the thirteen members states a customs union, with internal tariffs set at zero and a common external tariff. In forming a customs union, likely the only realistic candidates for membership were some subset of the 13 states. Given that the states were to adopt a common external tariff, economic conventional wisdom is that internal tariffs should be set at zero. Thus, federal harmonization of tariffs, with external tariffs at a common level and with internal tariffs at a level of zero, was good economic sense.

²⁰ The Court has used this right of privacy to strike down restrictions on birth control, on abortion and on sodomy. *Constitution of the United States*, First Amendment: “Congress shall make no law respecting an establishment of religion, or prohibiting the free exercise thereof; or abridging the freedom of speech, or of the press; or the right of the people peaceably to assemble, and to petition the Government for a redress of grievances.”

Fourth Amendment: “The rights of the people to be secure in their persons, houses, papers, and effects, against unreasonable searches and seizures, shall not be violated ...”

Fifth Amendment: “No person ... shall be compelled in any criminal case to be a witness against himself, nor be deprived of life, liberty, or property, without due process of law; nor shall any private property be taken for public use without just compensation.”

Ninth Amendment: “The enumeration in the Constitution, of certain rights, shall not be construed to deny or disparage others retained by the people.”

²¹ Choplecki (1992) argues that at least until the 1890s, “[T]he right to privacy was developing ... as an outgrowth of property rights. The Third, Fourth, Fifth and Fourteenth Amendments ... all protected people and their property against government intrusions.” The Third Amendment essentially gives the federal judiciary power over a wide variety of cases. See footnotes above for the Fourth, Fifth and Fourteenth Amendments.

On theoretical grounds, tax harmonization in the EU is likely to be at rates that are higher than optimal for the interests of the EU. Tax harmonization is thus likely to harm the average EU member state and its citizens, and to deplete member-state goodwill towards the EU.

Incentives in Federal Harmonization. There is little reason to think that any federal government makes harmonization decisions in general with an eye towards maintaining or increasing the reservoir of goodwill. Instead, it appears that effects on goodwill are mostly ignored in making individual federal decisions, and these decisions thus have external effects on goodwill towards the federal government. Further, a series of decisions with negative externalities are likely to have cumulative effects on good will (as would a series of positive effects). As seen below, it is quite easy for federal harmonization to be of the type that drains goodwill; thus, it is likely that on balance the external effects on goodwill are negative.

At the federal level, member states tend to push for what they view as their self-interest, often with little concern for the damage a given decision does to the health of the federal system—a negative external effect. Powerful senators from Mississippi have used federal regulations and subsidies to maintain a large but inefficient shipbuilding industry in their state over the decades since the second world war, and these senators have shown little concern for the costs imposed on the rest of the states. Federal bureaus tend to develop their own self-interests and clienteles, and to focus on these rather than the overall health of the federal system—again, a negative externality. Agencies such as the Agriculture Department strongly tend to represent the interests of various farm groups rather than the interests of the U.S. as a whole. To be sure, representatives from member states as well as federal bureaucrats may sincerely wish the federal system as a whole to prosper. The essence of externalities is that these decision makers do not take full account of the externality on goodwill in their cost-benefit calculus.

In the U.S., the federal government sets minimum wage levels that apply everywhere in the country. Many states also have minimum wage laws, though they must be at least as stringent as federal standards. States with more generous minimums sometimes push to have federal standards raised. Similarly, on a variety of issues, unions have succeeded in having national labor standards imposed by Congress or by executive orders that supersede less generous state standards.

Incentives to Harmonize at Too Stringent Levels A federal system contains strong incentives to push for harmonization of standards at too stringent levels. Take an example. Suppose French tax rates are higher than optimal, and that the lower British tax rates are at the optimal level for the EU. If France is unwilling to cut its rates, it may push for harmonization at high rates, to remove its competitive disadvantage vis-à-vis lower-tax EU countries such as Britain. Britain of course has an incentive to keep things as they are rather than to harmonize at high rates.

Britain likely does not have an incentive to push for harmonization at its low tax rates, however—this would destroy some of its competitive advantage vis-à-vis high-tax EU countries. To be sure, harmonization at the low end of the range of EU rates would benefit the EU as a whole, but the net effects on Britain would be less beneficial than for other EU countries, and might be negative. Further, Britain would have to expend political capital to produce gains that accrue mostly to others—and the others may not be at all grateful. A country is loath to spend political capital on projects that largely benefit others. Harmonization is thus more likely to be pushed for by countries that have tax rates or regulations more stringent than optimal.

Further, countries are more likely to favor harmonization in general if they are powerful at the level of federal decision-making. With such power, they have a chance to get harmonization they like and to kill harmonization they do not.

Thus, countries have an incentive to sort themselves based on (a) the stringency of their regulations relative to most EU countries, and (b) their political power at the federal level. If a country is large, and thus likely has more power at the federal level, *ceteris paribus*, and if it has relatively stringent regulations, then that country has an incentive to favor a federal system where harmonization is easy to achieve and where there are relatively loose constitutional limits on the scope and depth of possible harmonization. A small country with relatively mild regulations has an incentive to adopt a general “states rights” position, where harmonization is difficult to impose and there are strong constitutional limits on the scope and depth of possible harmonization. Such a country might favor requiring super majorities to impose most types of harmonization, and, more strongly, might favor including in the constitution only a narrow list of areas that are subject to harmonization.

Nordic countries may be torn. They have stringent environmental regulations, high taxes, elaborate welfare systems and highly regulated labor markets. In intra-EU competition, they are likely to benefit from federal harmonization at the stringent end of the spectrum. Because they are small, however, under many systems of weighted voting they have little power individually at the federal level, and may be unable to block particular instances of harmonization that they strongly oppose. *Ceteris paribus*, countries with little power at the federal level have an incentive to favor strong restrictions on the federal government’s powers to impose harmonization, including tax harmonization.

Heterogeneous Tax Rates in the U.S. Firms and households in the U.S. are subject to federal, state, local and special-district taxes. Federal taxes are homogeneous across the states; in general, federal tax laws cannot discriminate across states.²² State sales taxes, income taxes and property taxes show great heterogeneity. Some states have no sales tax and some have no income tax. Maximum sales taxes are close to 10 percent in some states, and some states have

maximum income tax rates well in excess of 10 percent (with the tax schedule steeply progressive). Some states tax all sales, and other states have lower or zero tax rates on some goods (for example, food or some baby-care products). Local taxes, by cities or counties, etc., include property taxes in particular, but also sales and income taxes, and these vary widely across jurisdictions. The effective tax rate on the market value of a house can vary by a factor of five across states; many cities have no income taxes, and impose low or no sales taxes in addition to state sales taxes. Special districts are sometimes set up to deal with water, sewage, roads, etc., and the nature of these districts and their charges vary widely. Thus, there is an extraordinary range of marginal income, sales and property tax rates that firms and households face across locations. There is much anecdotal evidence that some firms and households pay serious attention to differential tax rates in making decisions on location. There is similar anecdotal evidence that, when setting their tax rates, governments sometimes feel forced to consider the competitive effects their taxing has on attracting firms and households.

Restrictions in the U.S. Constitution see to it that in practice the federal government cannot impose harmonization of state, local and special-district tax rates across the U.S. This example does not mean that the EU should adopt similar or indeed any constitutional limitations on the ability of federal institutions to force tax harmonization. Rather, the U.S. is an example of a federation where substantial heterogeneity in tax rates has not prevented economic success. To be sure, heterogeneous tax rates under federalism are likely to be associated with economic inequality (Wildavsky 1998b), though perhaps at a high average level of income as in the U.S. As was argued above, incentives in harmonizing tax rates across member states are likely to lead to higher than optimal tax rates.

²² At least explicitly. The federal tax code is complicated, and some parts affect only a relatively few people or corporations, and those affected are sometimes concentrated in one or a few states. A powerful senator or representative may be able to secure a disproportionate number of breaks for home-state residents.

Contrast with Harmonization of Defense and Foreign Policies. On many economic issues, France has stringent economic standards and thus has an incentive to push for harmonization at stringent EU standards. Further, France is large and has substantial political power at the federal level to block harmonization it strongly opposes. Nevertheless, many French policy makers are skeptical of harmonization of EU foreign and defense policies in a unitary system that some observers envisage, rather than a system in which individual nation states continue to play strong defense and foreign policy roles, at time independent roles. The incentives to push for economic harmonization are different from those for harmonization of defense and foreign policies. These considerations suggest that some EU countries might see advantages to pushing for substantial harmonization in some areas, for example, social and economic policy, but for only loose harmonization in other areas, for example, defense and foreign policy.

Harmonization at the United Nations Level. One strategy for such countries is to be in favor of harmonization in general, but to push for only some types of harmonization at the EU level, for example, economic and social policies. These countries might advocate harmonization of defense and foreign policies, but push for harmonization through negotiations and treaties at the level of the United Nations. In particular, the EU might devote its defense and foreign policy harmonization to such efforts as treaties on the International Criminal Court and global warming, but not to creating integrated, centralized EU military forces that are substantially independent of NATO and are subject to qualified majority EU voting.

Another possibility is for the EU to use “variable geometry” or “variable speeds” in harmonizing foreign and defense policies. Arrangements might be made for traditional neutrals (Sweden, Ireland, Finland) to go their own way. For another subset of countries, some arrangements may allow for action by qualified majority voting but also allow for opt-

outs for members of this sub-set that disagree. For example, for a subset of countries, qualified majority voting may decide official EU policy on use of military force, but the contribution by each member state may be largely voluntary and decided on a case-by-case basis.²³

Harmonization of Defense and Foreign Policies in The U.S. One of the main purposes of writing the U.S. Constitution in 1787 and adopting it in 1787-1790 was to ensure that defense and foreign policies were wholly centralized at the federal level. The thirteen states, organized then under *The Articles of Confederation*, faced very different circumstances from EU members. The states were surrounded by hostile powers: The British in Canada, the Spanish in the Floridas, as well as the Spanish in New Orleans, with the French still interested in reacquiring their former North America possessions of Canada and Louisiana, and all three countries in the Caribbean. The eighteenth century saw a great deal of war; periods of peace were more like breathers between wars than peace. It was difficult for small states to avoid choosing sides in these great-power wars. In particular, New England engaged in a good deal of shipping, and the Southern states were heavy agricultural exporters; they had to have some way of dealing with Britain, the dominant sea power of the age. Either the American states could centralize defense and foreign policy, or each state would be under tremendous pressure to accept junior partner status in alliance with one of the great powers: Britain, France, Spain, Russia, Austria-Hungary and other more minor powers such as The Netherlands, Prussia, Portugal, Sweden, etc. Rather than risk becoming entangled in the shifting pattern of European alliances, the states adopted the Constitution, which reserved all defense and foreign policy matters for the federal government.²⁴

²³ NATO's Article 5 provides for common defense when a member state suffers external attack. The contributions of each country are not specified, however, and the discussions after September 11, 2001, hijacking attacks made clear that Article 5 may in practice require only very modest contributions, for example, over-flight rights or rights to use airbases for some but not all purposes.

²⁴ *Constitution of the United States*, Section 1, Section 8: "The Congress shall have power To lay and collect Taxes, to pay the Debts and to provide for the Common Defense and general Welfare of the United States ... To regulate Commerce with foreign Nations, ... To define and punish Piracies and Felonies committed on the high

The member states of the EU are in very different circumstances as regards centralizing defense and foreign policies. Many are already members of military alliances with non-member states (e.g., Nato). A number have a more-or-less long tradition of neutrality (Sweden, Ireland, Finland, Austria). The pressures for joining any alliance are much less strong than in the late eighteenth century. The history of the U.S. shows that the possible costs of centralizing defense and foreign policies can be great. Centrifugal forces on the Union were substantial during the undeclared war with France in the late 1790s, the War of 1812 against Britain (1812-1815), and the Mexican War (1846-1848). Similar pressures arose because of the Embargo on trade (1807-1809) imposed in an effort to prevent being dragged into the Napoleonic wars. New England threatened to secede in all these cases, and the pressures towards secession during the War of 1812 were strong (Banner 1970).

5. Harmonization of Commercial Codes

Harmonization of commercial codes is usefully viewed from a constitutional perspective. Should commercial codes be wholly federal, or important parts left to member states? On the one hand, a federal commercial code is uniform across member states and thus reduces transaction and information costs, compared to leaving important code issues to member states. Further, many states may retain codes for long periods that are sub-optimal compared to a given federal code. On the other hand, if member states are notably heterogeneous, a federal code may fit poorly with other institutions of member states, causing potentially large costs. Further, leaving codes to the states leads to competition across states, and this competition may generate forces for change for the better. Competition also generates information about the effectiveness and costs of different commercial codes. Because any initial code of a member country is likely to be sub-optimal, and is likely to become less

seas, and Offenses against the Law of Nations... To declare War ... To raise and support Armies ... To provide and maintain a Navy ... To provide for calling forth the militia ... To provide for organizing, arming, and disciplining the Militia ...” Section 10: “No State shall enter into any Treaty, Alliance, or Confederation ...”

optimal over time, information on how to improve codes is valuable. In many cases, it may be easier to learn and adapt from member states than from other countries.

Sometimes harmonization involves only one part of an interrelated set of issues. In such a case, harmonization implicitly requires many other adjustments in a given country's laws if harmonization is to work well. Conversely, if the other, interrelated laws are not adjusted, or are adjusted poorly, harmonization may injure the member state. These general points apply to harmonization of commercial codes. To the extent that business practices differ sharply across EU member states, a harmonized commercial code that fits well with some states' business practices may fit poorly with other states' practices. For example, accounting standards and practices differ substantially across the EU countries. Countries that are damaged by harmonization must then limp along under a federal commercial code that is sub-optimal for them, or must change other, substantial parts of their business practices. Even if the harmonized commercial code and the new business practices associated with it are better on balance in the long run than the country's previous system, the costs of changing the system may be large enough in present value terms that the country suffers from the harmonization. It is quite possible that the average member state perceives itself as losing in present value terms from the harmonization. Analytically, the issue is first, whether starting from scratch a harmonized federal code would be superior to adopting the spectrum of codes across the member states. But, second, given that the spectrum is in place, would the superior benefits of the harmonized federal code justify the costs entailed in adjusting institutions to the new code.

6. Some Conclusions

The EU is considering a constitution. One major class of issues to consider is restrictions on the powers of EU federal institutions. In turn, a major question is the extent to

Article 2, Section 2: "The President shall be Commander in Chief of the Army and Navy of the United States and the Militia of the several States when called into service of the United States ...

which it is prudent to allow federal institutions to compel harmonization of economic laws, regulations, and rules across member states. This paper looks at two concrete instances, harmonization of tax rates, and harmonization of commercial codes. In both instances, U.S. practice is a combination of some federal harmonization, but with a good deal of heterogeneity across states. On theoretical grounds, tax harmonization in the EU can be expected to set tax rates for the EU that are too high compared to other countries, and thus damage the EU in international competition. This suggests that it may be prudent for an EU constitution to include stringent limits on the power of federal institutions to impose tax harmonization.

The matter is less clear with harmonization of commercial codes. On the one hand, a federal commercial code that is uniform across member states reduces transaction and information costs, compared to leaving important code issues to member states. Further, many states may keep codes for long periods that are sub-optimal compared to a given federal code; states cannot be counted on to rapidly adopt what is best practice. On the other hand, there are some subtle costs that may be important and are likely to be missed. A federal code may, however, fit poorly with other institutions of member states, causing potentially large costs. Leaving codes to the states leads to competition across states, and may generate forces for change for the better. Competition also generates information about the effectiveness and costs of different commercial codes. Because any initial code is likely to be sub-optimal, and is likely to become less optimal over time, information on how to improve codes is valuable. Likely it is easier to learn and adapt from member states than from other countries.

More generally, the EU and the U.S. have great authority in the area of police powers, but the EU has much less authority in the area of defense and foreign policies and much less authority to extract taxes from EU citizens. For the health of the EU, a new EU constitution may well put strong explicit limitations on any growth in EU taxing powers and

EU control over defense and foreign policies. Further, likely the EU's ability to exercise police powers should be reduced and limited by explicit grants of power in some areas, with all other powers reserved to the member states. In all three cases, these suggestions follow from the effects of EU power on the goodwill that its citizens have towards it. Generalized resentment by citizens translates into a diminished pool of the goodwill that the EU needs to function smoothly, indeed to function successfully. In the limit, resentment can grow so massive that citizens turn to talk of secession and even act on this talk. Of course, the U.S. federal government experiences the same type of resentment, and citizens are skeptical of federal policies, but there appears to be little sentiment for secession.

The analysis above suggests that a EU constitution might well put explicit limitations on the police powers that the EU can exercise. Police powers include regulation of economic and social relations, public health, public morals and crime. These police powers reach deep into the life of citizens, and EU exercise of police powers is a main source of resentment that citizens of many countries feel against the EU. Based on experience with the expansion of the EU's exercise of police powers, it appears that the EU is likely to be ever more deeply involved in the lives of its citizens, and that its citizens are likely to become increasingly resentful. It is not at all clear that EU citizens benefit on net by increasing federalization of police powers at the EU level.

When the Framers wrote the U.S. Constitution in 1787, it was clear to most of them, and to a majority of U.S. citizens, that defense and foreign policies had to be federalized. The alternatives were too dangerous and unsatisfactory. In the twenty-first century, there is a great deal of dispute over federal exercise of its powers over defense and foreign policies. These disputes are nothing new; most major U.S. policies have had many domestic opponents. Nevertheless, there is little sentiment for reducing federal powers over defense and foreign policies, just for redirecting their use in one case or another. Some think that interventions

such as Somalia and Haiti are misguided. Many opposed the Iraq War. Some hope to get better policy outcomes by giving more power to Congress, less to the president, but few hope substantially to reduce those powers. Some want to spend less on defense, and use the saved funds elsewhere; the argument generally turns on cutting waste in defense programs, rather than deliberately weakening defense. Similarly, many would have the U.S. run a more isolationist policy—unilateralism with significantly reduced activity. Some would have the U.S. run an activist policy, but one that was approved by allies and international institutions—multilateral activism.

The EU has a much wider range of choices than the U.S. in how much to federalize power in the defense and foreign policy areas. At present, the EU cannot force member states to speak with one voice in foreign policies or to act with one will in defense policies. Many EU citizens are satisfied with the current arrangements. Many, however, seek to have the EU exercise greater powers in defense and foreign policies. In the limit, many foresee the EU as a whole having only one foreign policy, and perhaps only one defense policy (with some opt-outs). For the present, and likely for a very long time, there is not enough homogeneity in opinions across EU member states for strong federalization of defense and foreign policies to be a healthy idea. In the early twenty-first century, many suggested that the EU should boycott Israel, and some argued a boycott should be a mandatory action that all member states must adhere to. Such a boycott could not be imposed and enforced now, but many look forward to a day when the EU would have such power. Coercing reluctant states and their citizens into following a boycott that they oppose would put great pressures on the EU. For many, it might become a matter of principle over which they would be willing to break up the EU than compromise. Of course, an EU war that had great dissent across member states would be even more likely to strain or fracture the EU.

To a federal bureaucrat, all problems tend to look like federal problems. In many cases, however, member states do not perceive federal solutions imposed on them as better than allowing states to go their own way. In such cases, federalization reduces the reservoir of good will on which the federation's successful functioning depends. This depletion is an externality that federal bureaucrats do not take into account in their decisions on how far to push harmonization. One solution is to impose constitutional limits on the extent to which federal institutions can impose harmonization.

Note that limits on federal powers to require harmonization are not the same thing as limits on the powers of government to intervene in the economy. Strict limits on federal powers are consistent with substantial economic intervention by individual member states. Indeed, in the formative period of the U.S., from say 1780 to 1800, states were quite active in the economy in the form of protection, subsidies and regulations, and this was viewed as normal.

Isaiah Berlin (2002) discusses two concepts of liberty. In the first, liberty consists of the individual's right to have a say in what his/her government does, in particular, what the government does to him/her. In the second, liberty consists of the individual's right to areas of private activity where the government has no say, or a limited say, over what the individual does.

Americans conceded powers to their colonial governments and then to their state governments that they would not concede to a central government. At the same time, Americans conceded only limited powers to colonial and then state legislatures, under the second concept of liberty. The Americans insisted on both forms of liberty. Representative government ensured the individual had a say in what the government did, the first meaning of liberty. Government limited by a written constitution that enumerated its powers, with the rest restricted to the states or the people, ensured that there existed areas of private activity where

the federal government had no or limited say, the second meaning of liberty. All of the EU member states have constitutional guarantees for their citizens to participate in governing themselves, and these states thus ensure their citizens liberty in the first meaning. Giving citizens of EU states indirect representation in EU decision-making may formally solve the problem of “democratic deficits.” It does not, however, solve the problem that citizens demand guarantees of liberty in the second meaning. In federal systems, explicit constitutional limits on the federal government are one means for guaranteeing liberty in the second meaning.

Table 1. Federal Government *Civilian* Employment

Year	Total	DC	All Others	Post Office	Population ¹	DC/ Total	PO/ All Others	All Others/ Population ⁴
1970	2,981,574	327,369	2,654,205	741,216	203.302	.1098	.2793	1.303 %
1881	100,020	13,124	86,896	56,421	50.189	.1312	.6493	0.173 %
1871	51,020	6,222	44,798	36,696	38.558	.1220	.8191	0.132 %
1861	36,672	2,199	34,473	30,269	31.443	.0600	.8780	0.110
1851	26,274	1,533	24,741	21,391	23.191	.0584	.8646	0.107
1816	4,837	535	4,302	3,341	8.439 ²	.1106	.7766	0.052 % ⁵
1804	2,267	293	1,974	NA	6.274 ³	.1293	NA	0.032 % ⁶

¹ In millions. For 1970, 1880, 1870, 1860, 1850, 1820 and 1810, 1810 and 1800.

² Population is average of those for 1810 and 1820 (7.239 million and 9.638 million).

³ Population is average of those for 1800 and 1810 (5.308 million and 7.239 million).

⁴ In percent.

⁵ Average of ratios using populations for 1810 and 1820 (0.0446 and 0.0594).

⁶ Average of ratios using populations for 1800 and 1810 (0.02726 and 0.03719).

References²⁵

- Adams, Henry. *New-England Federalism. 1800-1815*. Boston: Little, Brown, and Company, 1905 (1887).
- Articles of Confederation, The*. Available on-line at The Avalon Project at Yale Law School.
- Banner, James M., Jr. *To The Hartford Convention: The Federalists and the Origins of Party Politics in Massachusetts, 1789-1815*. New York: Knopf, 1970.
- Berkin, Carol. *A Brilliant Solution. Inventing the American Constitution*. New York: Harcourt, 2002.
- Berlin, Isaiah, "Two Concepts of Liberty," in Isaiah Berlin, *Liberty*, ed. Henry Hardy. Oxford: Oxford University Press, 2002.
- Bowen, Katherine Drinker. *Miracle in Philadelphia*. Boston: Little, Brown and Co., 1966.
- Choplecki, Mary, "The Property Rights Origins of Privacy Rights," *The Freedman* 42 (August, 1992).
- Constitution of the Confederate States of America, The*. Available on-line at The Avalon Project at Yale Law School.
- Constitution of the United States of America, The*. With amendments. Available on-line at The Avalon Project at Yale Law School.
- Economist, The*. September 14, 2002, p. 33; October 5, 2002, p. 36; October 12, 2002, pp. 41-42.
- Farrand, Max. *The Records of the Federal Convention of 1787*. Vols. 1-4, rev. ed. New Haven: Yale University Press, 1937 (1911).
- Fleming, Thomas. *Duel*. New York: Basic Books, 1999.
- Goldwin, Robert A., and William A. Schambra, eds. *How Capitalist Is The Constitution?* Washington, D.C.: American Enterprise Institute, 1982.
- Hamilton, Alexander. *Notes of Alexander Hamilton in the Federal Convention of 1787*. Available on-line at The Avalon Project at Yale Law School.
- King, Rufus. *Notes of Rufus King in the Federal Convention of 1787*. Available on-line at The Avalon Project at Yale Law School.

²⁵ When revised or reprinted volumes are used, the most common previous publication date is typically given in parentheses.

Lansing, John, Jr. *The Delegate from New York or Proceedings of the Federal Convention of 1787 from the Notes of John Lansing, Jr.* Joseph R. Strayer, ed. New Jersey: Princeton, 1939.

Madison, James. *The Debates in the Federal Convention of 1787, which framed the Constitution of the United States of America, reported by James Madison, a delegate from the state of Virginia.* Eds. Gaillard Hunt and James Brown Scott. Oxford: Oxford University Press, 1920. Available on-line at The Avalon Project at Yale Law School.

McDonald, Forrest, "The Constitution and Hamiltonian Capitalism." In Goldwin, Robert A., and William A. Schambra, eds. *How Capitalist Is The Constitution?* Washington, D.C.: American Enterprise Institute, 1982.

McDonald, Forrest. *States Rights and the Union. Imperium in Imperio, 1776-1876.* Lawrence, Kansas: University Press of Kansas, 2000.

McDonald, Forrest. *E Pluribus Unum. The Formation of the American Republic.* 2nd ed. Indianapolis, IN: Liberty Fund, 1979 (1965).

McDonald, Forrest. *Novus Ordo Seclorum. The Intellectual Origins of the Constitution.* Lawrence, Kansas: The University Press of Kansas, 1985.

McHenry, James. *Papers of Dr. James McHenry on the Federal Convention of 1787.* Available on-line at The Avalon Project at Yale Law School.

McPherson, James M. *The Battle Cry of Freedom.* New York: Oxford University Press, 1988.

Miller, William. *The Business of May Next.* Charlottesville: University of Virginia Press, 1992.

NARA (National Archives and Records Administration), *Constitution web page.*

Paterson, William. *Notes of William Paterson in the Federal Convention of 1787.* Available on-line at The Avalon Project at Yale Law School.

Pierce, William. *Notes of Major William Pierce (Georgia) in the Federal Convention of 1787.* Available on-line at The Avalon Project at Yale Law School.

Smith, Jean Edward. *John Marshall: Definer of a Nation.* New York: Henry Holt and Company, 1996.

Vreeland, Hamilton, Jr. *The Twilight of Individual Liberty.* New York: Charles Scribner's Sons, 1944.

Wildavsky, Aaron. *Federalism and Political Culture.* Eds. David Schleicher and Brendon Swedlow. New Brunswick, NJ: Transactions Publishers, 1998.

Wildavsky, Aaron, (a) "A Bias Towards Federalism," in Aaron Wildavsky, *Federalism and Political Culture*, pp. 17 – 37.

Wildavsky, Aaron, (b) “Federalism Means Inequality,” in Aaron Wildavsky, *Federalism and Political Culture*, pp. 39 – 54.

Yates, Robert. *Notes of the Secret Debates of the Federal Convention of 1787, Taken by the Late Hon. Robert Yates, Chief Justice of the State of New York, and One of the Delegates from That State to the Said Convention*. Available on-line at The Avalon Project at Yale Law School.