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Economic Policy in the European Union

Sixten Korkman

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To Marit

‘Say what you want about the music of Wagner, but you have to admit that it is actually much better than it sounds.’

Mark Twain

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Abbreviations

BEPG	Broad Economic Policy Guidelines
CAP	Common Agricultural Policy
CEPR	Centre for European Policy Research
CFSP	Common Foreign and Security Policy
COREPER	Committee of Permanent Representatives
ECB	European Central Bank
ECJ	European Court of Justice
ECSC	European Coal and Steel Community
EDP	Excessive Deficit Procedure
EEC	European Economic Community
EFC	Economic and Financial Committee
EFSA	European Financial Supervisory Authority
EFTA	European Free Trade Area
EIB	European Investment Bank
EMU	Economic and Monetary Union
EP	European Parliament
EPC	Economic Policy Committee
ESCB	European System of Central Banks
FP	Financial Perspective
GDP	Gross Domestic Product
GNI	Gross National Income
HST	Home State Taxation
IGC	Intergovernmental Conference
IIA	Interinstitutional Agreement
IMF	International Monetary Fund
KIP	'Key Issues Paper'
LDCs	Least Developed Countries
NCB	National Central Bank
OECD	Organisation for Economic Cooperation and Development
OCA	Optimum Currency Area
OMC	Open Method of Coordination
OR	Own Resources
PPS	Purchasing Power Standards
QMV	Qualified Majority Voting
SEA	Single European Act
SGP	Stability and Growth Pact

SME	Small and medium-size enterprise
SOE	Small Open Economy
TARGET	Trans-European Automated Real-time Gross Settlement Express Transfer system
TEN	Trans-European Network
UN	United Nations
VAT	Value Added Tax
WP	Working Party
WTO	World Trade Organization

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Preface

European countries are close to each other geographically and politically; their economies are integrated and interdependent. National policies have significant cross-border effects on neighbouring countries, and the spillovers risk giving rise to distortions and tensions. Cooperative action at the European level is needed in order to avoid conflicts and to achieve efficiency.

The European Union manages interdependence of member states by articulating and enhancing common interests through collective action, including common policies and joint governance within a framework of supranational institutions. This endeavour faces considerable hurdles in the form of practical difficulties and political sensitivities. Many of the features of the EU can be understood only in the light of a fundamental ambivalence in public attitudes towards European integration: the cross-border effects and common interests are acknowledged (if understood), but citizens' sentiments of identity, loyalty and solidarity continue to have a strongly national orientation. Member states are hesitant or unwilling to relinquish national control in favour of Community institutions, unless the powers of the Community are ring-fenced and/or unless their exercise remains subject to sufficient national influence. There is a constant need to 'make the case for Europe', and to make it in comprehensible language and with clear arguments.

The EU is, as has often been pointed out, an economic giant but a political dwarf. Also, it is institutionally complex and there is more than one truth about the EU. It may be portrayed as a supranational bureaucracy geared to undemocratic and intrusive action. It can also be perceived as an innovative system which in subtle ways has succeeded in surmounting the antagonistic barriers associated with national frontiers and thereby in safeguarding peace and prosperity in Europe. There are pronounced differences of view not only with regard to what the EU is but even more so with regard to how it should develop and what it should become.

This book attempts to understand and assess the EU in general and its economic policy regime in particular. It examines the logic of collective action with a view to answering the two-fold question: when is collective action called for? (as compared to leaving matters to private initiative and markets); and when is supranational action needed?

(that is, a transfer of discretionary political power to the Community level) as compared to leaving matters to national governments and intergovernmental cooperation? The rationale of the EU can be clarified only by examining and answering this two-fold question and the book sets this out in general terms (Chapters 1 and 2), in the context of macroeconomic policies (Chapters 5 and 6), structural policies (Chapter 7), taxation (Chapter 8) and the Community budget (Chapter 9). It also examines the differences between intergovernmental and supranational action (Chapter 3), describes the institutional set-up of the EU (Chapter 4), and makes some comments on key aspects of the EU's economic performance and its system of governance (Chapter 10).

In writing the book, I have tried to give due attention to the different perspectives that are necessary to understand the role and functioning of the Community. The policy issues are examined in terms of economic theory, drawing notably on the macroeconomic theory of open economies as well as on public sector economics and the theory of public choice (the economic analysis of political behaviour). The legal and institutional framework of the EU is described in some detail, and problems are in many instances illustrated by historical episodes and events that are of interest not only in themselves but also because they highlight issues of principle. A broad approach is needed because a good understanding of the problems and prospects with which economic policy in the EU is confronted requires a multiple perspective, one that combines analysis of economic and political principles with considerations reflecting the institutional reality of the Community and practical experience of its decision-making.

Upon arrival in Brussels in 1995, I was overwhelmed by the complexity and the opacity of the European Union's system of economic governance. That I should write a book to clarify my thoughts was first suggested by my former assistant, Marisa Penocchio, who did much to help me understand the *modus operandi* of the Council. I am grateful to her and to her successor, Alexandra Almeida, as well as to collaborators who have checked various parts of the text (including Andrew George, Bodil Nielsen, Ilkka Saarilahti, Servatius van Thiel and Kyle Galler). Chapter 4 is based on my contribution to Westlake and Galloway (2004); permission to reproduce that material is gratefully acknowledged. While most of the book can be read without any training in economics, some familiarity with elementary macroeconomics should facilitate the reading of Chapters 5 and 6. It goes without saying that the responsibility for the views expressed in this book, and for remaining errors, is mine and mine alone.

Sixten Korkman

1
Introduction

The ambition of this book is to put into perspective and assess the economic policy regime of the EU. To do so, it is necessary first to consider in general terms the rationale for economic policy and the role of the EU. Yet economic policy is a vast topic in its own right, and so is the EU. The limited purpose of this chapter is therefore only to pave the way for what follows by considering certain elements of answers to the two broad questions: (1) what is (the basis of) economic policy? and (2) what is (the essence of) the EU?

1.1 The basis of economic policy

Economic policy refers to action by public authorities, notably national governments, with a view to influencing economic circumstances and developments. An enquiry into the economic policies in the EU may therefore usefully begin by considering the role of the nation state and its government. These remain the main building blocks of the European political landscape. Government action has a pervasive influence on the lives of citizens, from cradle to grave, and the governments of member states are the key political actors in the EU. An additional reason for reflecting on the role of government is the interesting parallels that may be drawn between the political philosophy underlying the EU and the contract-theoretical perspective on the origin of the state.

1.1.1 The state and the government

Conceptually one may think of political authority as being based on a social contract. This notion, which has its origins in ancient Greece, was made famous three-and-a-half centuries ago by Thomas Hobbes. In *Leviathan* (1651), he considered a hypothetical world in which people live without being governed, without forming organised societies. According to Hobbes, this 'state of nature' would be characterised by widespread theft and violence such that the life of man would be 'solitary, poor, nasty, brutish and short'. To avoid a state of permanent war 'of every man against every man', Hobbes suggested all men should agree a political authority with unlimited powers to settle disputes. In this bleak choice people would sacrifice their individual liberties to the state in order to avoid anarchy and to enjoy the benefits of security.

A more palatable proposal, constraining the scope of political authority, was made by John Locke in his *Two Treatises of Government* (1689). To improve their lot, people could agree a 'constitutional contract' defining property rights, imposing constraints on individual behaviour and creating mechanisms for enforcing the contract. In Locke's conception, the ruler is an agent who acts for the citizens and remains under their control, being 'hired and fired' by the people he governs. The state ensures the security of its citizens, yet there are clear limits on the authority and power of the ruler.

Setting up the state and endowing it with political authority is in this ('contractarian') tradition seen as something that individuals consent to willingly in order to pursue their common interests through collective action. Needless to say, the notion of political authority based on social contract is not a historical account of the emergence of the state, only a thought-experiment intended to shed light on the rationale (or the ethical justification) for its existence. As such it accords well with social and political analysis focused on interactions between individuals inclined to rational choice, and the contract-theoretical perspective has enjoyed widespread popularity in modern times.[1] It strikes a chord particularly with economists because the social contract setting up state and government may usefully be seen as a 'public good' and as a cooperative solution to the famous 'prisoners' dilemma', a particular case of game theory so named after the example originally used to illustrate it.

Game theory perceives individuals as players, each deciding on his or her move without full information about the action of others. Analysis of the prisoners' dilemma brings home the point that individually rational behaviour may not, in the absence of coordination, ensure a socially desirable outcome (see Box 1.1). Also, coordination may not come about spontaneously but may have to be imposed by a central authority.

Box 1.1 The state as a cooperative solution

Assume that individuals *A* and *B* may spend their time on some productive activity (like hunting or growing cattle) or on stealing from each other. Stealing may be the preferred option, if it offers the perspective of easy reward for little toil and trouble, but becoming the victim of theft is a calamity. The situation resembles a game in that the outcome of a particular choice is uncertain because each individual will know the action of the other only after having made his own decision. The possible outcomes are set out in Table 1.1, with the options of individual *A* in the rows those of *B* in the columns, and with *P* indicating productive activity and *S* stealing. The ranking of the outcomes is given by the numbers 1 to 4 from the point of view of individual *A*, and with the corresponding ranking for *B* in brackets. (The structure of the pay-offs is the same as in the prisoners' dilemma.)

Table 1.1 The prisoners' dilemma

		B	
		P	*S*
A	*P*	2 (2)	4 (1)
	S	1 (4)	3 (3)

The point of the table is to demonstrate that individually rational behaviour may lead to socially undesirable outcomes. To see this, note that it is rational for individual *A* to choose the *S*-option: it is the dominant strategy because *S* gives a better outcome if *B* chooses *P* as well as if *B* chooses *S* (as is seen by comparing the respective rankings). Obviously the same holds for individual *B*. Thus, *S* will be chosen and both players end up with the outcome of rank 3, which is suboptimal or collectively inferior (as the outcome of rank 2 could be achieved if both players were to choose the *P*-option). The message is clear: rational choice by independent actors may lead to outcomes which are harmful for all (everybody stealing). Conversely, coordination or cooperation is justified if it leads to a mutually beneficial outcome (inducing everybody to engage in productive activity).

It might arguably be more appropriate to portray interaction between individuals as a sequence of decisions rather than as a unique event (the case considered in Box 1.1). In such a repeated game the players would be likely to form expectations for the future based on their experience in the past. They might become aware of their common interest in a cooperative solution. In particular, they might learn that non-cooperation risks leading to retaliation ('tit-for-tat'), and this might induce them to choose the cooperative solution (implicitly agreeing to abstain from stealing). However, there would always be the risk of one or the other of the players cheating, and the risk of such behaviour would be particularly relevant in the more realistic situation with a large number of players.

David Hume, two-and-a-half centuries ago, noted how a few neighbours might agree to drain a meadow but how a thousand people cannot agree since each will try to lay the whole burden on the others. Similarly, Adam Smith, while being a strong advocate of private enterprise and the market, considered one of the important duties of the ruler to be 'creating and maintaining certain public works and certain institutions, which it can never be for the interest of any individual, or small number of individuals, to erect and maintain; because the profit could never repay the expense to any individual or small number of individuals, though it may frequently do much more than repay it to a great society'.[2] Reliance on voluntary compliance in large communities is bound to lead to free riding and to underprovision (or no provision) of public goods. The bargaining costs of negotiations aimed at a voluntary solution would be prohibitive.

There are thus circumstances in which the only way of achieving effective cooperation is for all citizens to cede some sovereignty to the state and to have the government take collective decisions, hopefully in the light of good information about the preferences of its citizens. As emphasised already centuries ago by Hobbes, Locke, Hume, Smith and others (including Jean-Jacques Rousseau in *Du Contrat Social* published in 1762), there are rational and moral grounds for instituting a collective remedy for the resolution of problems of conflict and coordination. The state is in this perspective an instrument for pursuing our common interest by creating laws (outlawing stealing) and by setting up a government to enforce the laws, thus creating incentives for individuals to make choices which are good for them and good for others.

The basic features of *public goods* are that all can benefit from their production (jointness of supply) and that it is difficult to exclude citizens from their benefits (non-discrimination), as is true of a lighthouse on a coast or a statue in a park. A pure public good is one which must be provided equally for all citizens of a community. Familiar examples include national defence, police and fire protection, but also systems of property rights and mechanisms for their enforcement. The market economy is in this sense no alternative to the public sector but can exist only because it is created and upheld by a sophisticated system of government and administration. The basic (classical or liberal) rationale for the public sector is the need to provide collective goods, like law and order, and notably the need to uphold property rights and the legislation underpinning the market economy. The link between the game-theoretic considerations and public goods is that the latter can typically be seen as cooperative solutions to games of the prisoners' dilemma category. Each individual might prefer to have the benefits of public goods without paying for them, but everybody cannot be a free rider. All citizens stand to benefit by contributing to government for the provision of public goods as compared to the case where no public goods are provided.

The role of the state and government is thus to provide public goods, which cannot be supplied by private enterprise on markets or through voluntary cooperation. The common interests of citizens is the rationale for the defining characteristic of government, its monopoly of coercive power, which includes the power to regulate and to tax. This is indeed the basis of economic policy, most of which boils down to regulation, taxation or spending programmes (or some combination of these). However, while public goods offer a rationale for government, they do not justify big government. Most goods remain 'private goods' and can be provided by private companies competing in free markets. Economic theory demonstrates that the market is, under certain conditions, an efficient mechanism for allocating the resources of the economy. The role of the protective ('nightwatch') state is to create the preconditions for the market economy, not to substitute for it.

1.1.2 Market failure

A main message of (classical) economic analysis is that the market or the price mechanism is a method for decentralising decision-making in economies based on specialisation. The market allows decentralisation by fulfilling three essential functions: it disseminates information about preferences and resource scarcities (through prices); it provides incentives to exploit economic opportunities (via profits); and it coordinates the decisions of individual actors (by market clearing). Furthermore, market clearing through the price mechanism is not only viable but, under certain conditions, also (Pareto) efficient. This means that no public interventions can alter the market outcome so as to improve the lot of one or several individuals without a deterioration in the position of (some) others; that is, public interventions cannot improve the market outcome so as to make everybody better off.

The big attraction and fascination of the market is that the working of the 'invisible hand' under pure competition translates independent (and presumably selfish) private decisions into a socially efficient outcome (a Pareto optimum).

This line of reasoning does not deny a role for the government, but implies that it should primarily be in the establishment and policing of property rights and competitive conditions in markets. Any government action going beyond this needs to be justified by pointing to specific circumstances, 'market failures', which call for complementary action on the part of the government or other policy-makers. (As will be seen in later chapters, there is no reason why national boundaries should coincide with the area relevant for market failures or for public interventions; action may also be called for at the EU level or even the global level.) Several instances of market failure have been extensively analysed in the public economics literature.[3]

The most important case of market failure, *public goods* has already been introduced above. These goods are vital to the functioning of the economy but cannot be supplied by private enterprises on markets; they need to be provided by public authorities. Otherwise each individual has an incentive not to contribute to their provision in the hope of free riding. Society and the economy need law and order, protection of the rights of citizens, including property rights. However, the overall legal and administrative framework applies to society as a whole and cannot be subject to market transactions.

Economic actions may give rise to 'spillovers' in the form of *externalities* (positive or negative) for third parties, in addition to those effects that are transmitted through prices and markets. Market prices will reflect private costs but not social costs (of externalities), and they will thus give wrong signals to consumers and producers whenever the social costs are significant. Environmental consequences of production and consumption are a case in point; households and firms do not necessarily have incentives to consider the harmful consequences of their behaviour for the rest of society. One might imagine that those causing and those suffering from externalities could limit them through voluntary agreements (a possibility explored in the so-called 'Coase theorem'), but in practice this is likely to be impossible. Instead, there is a case for government intervention through regulation as well as taxes and/or subsidies. Other important examples are basic research, education and cultural activities, which benefit not only the individuals and companies directly involved but may also have positive externalities for society at large.

Table 1.2 Rationale of economic policy

Create preconditions for markets
Provide public goods
Ensure competitive conditions
Manage externalities
Exploit scale effects
Take account of asymmetric information
Improve income redistribution
Reduce macroeconomic imbalances

It may not be possible for the private sector in competitive markets to undertake activities where *scale effects* are important and fixed costs are therefore considerable relative to variable costs (creating the conditions for a natural monopoly). This is the reason why governments have typically been involved in infrastructure projects like bridges, roads and ports.

Irrespective of whether the market is efficient or not, there is no guarantee that it will be 'fair' in the sense of resulting in a socially and politically acceptable distribution of income and wealth. Most governments therefore pursue policies of *income redistribution* through (progressive) taxation and income transfers, through social protection systems and by providing some key services (such as health and education) at subsidised prices. These policies may also be based on paternalistic considerations or limitations of private insurance related to problems of *asymmetric information*[4] and 'adverse selection'.

The case for *macroeconomic policies* is based on the (Keynesian) postulate that the price mechanism does not ensure an appropriate level of aggregate demand and activity in the short term. Demand constrained activity levels may imply unemployment above the 'natural' level, and demand exceeding capacity may cause inflationary pressure. Macroeconomic instability increases uncertainty and may weaken the long-run performance of the economy. Also, unemployment is both a waste of resources and socially undesirable. Macroeconomic policies are useful if they help to stabilise aggregate demand at a level compatible with the 'natural' or non-inflationary rate of unemployment.

There are thus several considerations that may be invoked for looking beyond isolated individuals and markets and to justify interventions to affect the allocation of resources, the distribution of income and aggregate economic developments. In particular, state intervention may be needed to ensure the conditions for an efficient resource allocation in the presence of market failures, to alleviate distributional inequalities created by the market, and to stabilise aggregate demand at a level conducive to a high level of economic activity. It should be underlined, though, that these are normative considerations explaining what the government is for and what it should try to do when perceived as an omniscient and benevolent actor pursuing the public interest (some Pareto-optimal allocation). What any government actually does may be a very different matter.

1.1.3 Government failure

The normative considerations reviewed above hardly explain why the public sector, as measured by the overall tax rate or public spending relative to GDP, is as great as it is in the member states of the EU. Expenditure on public goods as discussed above (national defence, law and order, public administration) probably accounts at most for some 10 per cent of GDP. However, in recent years total public expenditure in EU member states has on average amounted to almost half of GDP (ranging from 35 per cent in Ireland to 59 per cent for Sweden in 2003); collective consumption is a little less than a tenth, public investment 2–3 per cent, and total transfers as much as a third of GDP. Why is the public sector so great (particularly in Europe)? The answer to this question, which has been studied extensively in the 'public choice' literature, is that public spending is only vaguely related to cases of market failure. It has more to do with the ways in which the political system articulates, and translates into budgetary action, the views and interests of various socioeconomic groups on how best to enhance efficiency and fairness in society.

Many European voters (and not only those on the left) are suspicous of competitive markets and tend to see ample scope for government action not only to ensure a level playing field for unfettered competition but also to substitute for or to complement market activity. Opinion surveys as well as elections indicate widespread popularity of public provision of education and health services, as well as of social protection systems and transfer programmes aimed at alleviating poverty and income risks, including through comprehensive public pension schemes. Many of the goods and services provided by or paid for by the public sector are so-called 'merit goods' rather than public goods. These are goods or services (like health care and education), for which the government wants to encourage production and consumption beyond the levels that would otherwise occur. There is, notably in Europe, a clear political preference for the welfare state and thus for the public sector to assume a role going far beyond the 'nightwatch' state.

Much of the public choice literature argues that the political process, based on majority voting, is biased towards government expansion in favour of specific groups of the electorate, thus leading to big government and excessively generous welfare systems. Expenditure is focused on programmes that are of great interest to well-organised and vocal rent-seeking interest groups, while the costs of high taxes and big budget deficits are widely spread and attract less political attention. Also, voters may not give sufficient weight to the future tax burden caused by current budget deficits because of 'fiscal illusion' or because the future tax payers are under-represented in the democratic process, and bureaucrats may have their own reasons to expand government activity (even when inefficient). The harmful consequences of the public sector expansion bias include high taxes and large budget deficits detrimental to healthy economic activity. Government is, in this perspective, a self-aggrandising 'Leviathan' and its activism is part of the problem rather than the solution. Political incentives distort decisions in favour of excessive policy interventions with the result that 'government failure' undermines economic prosperity, being in itself a bigger problem than the market failure for which it is supposed to compensate.

Much criticism of government intervention is actually directed towards the majority voting with which it is normally associated. While majority voting is widely seen as the natural expression of democracy (and therefore perceived as legitimate), it also allows for the 'tyranny' of the majority over the minority. This is why one of the prominent critics of big government, James Buchanan, asks: 'But how is it possible for the persons to organise themselves collectively or politically so as to secure the genuine benefits from collective action without, at the same time, leaving open the prospects for exploitation?' His answer is to underline the need for constitutional limits on the scope of the democratic system (through restrictions on the scope for majority voting) as well as for rules that constrain government discretion in decision-making.

The role of the public sector remains controversial[5] and there is an ongoing debate between those expounding a liberal or market-oriented view on the one hand, and those favouring a more active and interventionist role for the government on the other. As noted by Kay (2003: p. 8), the former see self-regarding materialism as the dominant human motivation and consider that 'greed in business is virtuous because producing the goods and services people want is the only way to extract money from them', while 'greed in politics is disastrous, because politicians can use the coercive power of the state to get other people's money'. The view of 'market fundamentalists' is therefore that the political sphere should be as small as possible, that the economic role of the state should extend as little as possible beyond the definition of property rights and the enforcement of contracts. The protagonists of policy activism, by contrast, find ample justification for government intervention in the market failures reviewed above, and they take a markedly more optimistic view of the role that the political system can play. It is, needless to say, only natural that the different doctrines are reflected in the debate on policies at the EU level as well (as will be seen below).

1.2 The essence of the EU

There is no simple and consensual understanding of the character and role of the EU. While reference to the EU as a 'superstate' is nonsensical and only intended as a straw man to be attacked by its adversaries, it is undeniable that the EU has, for good reasons, acquired certain state-like features which in some areas help it substitute for or complement action traditionally associated with the nation state. One might refer to the EU as a 'federation of nation states' or as a 'federative association', a voluntary undertaking by its member states to pull together their powers and resources within a supranational framework, but without doing away with the nature of the participants as independent states. It might also be referred to as a 'partially federal entity', the connotation being that the federal character applies only to some of its dimensions.[6] This section will approach the EU from two complementary angles: by making a brief reference to its history, and in terms of an attempt to define it. The aim is to clarify the essential character of the EU, which risks being lost sight of when one is confronted with its institutional and political complexity (to be dealt with in later chapters).

1.2.1 Milestones of the EU

Europe is a continent of mostly small countries with multiple common borders and short distances. Economic integration in the form of large-scale trade and direct investment has been important in Europe for centuries and is increasingly so today. It allows international specialisation and contributes significantly to economic prosperity. However, the cross-border effects of economic activity, and notably of unconstrained policies geared to national interests, have also created problems and contributed to international tensions. Trade has at times been restricted and distorted by tariffs and competitive devaluations, as happened particularly in the period between the world wars, to the detriment of global growth and stability. The history of Europe in the last century testifies to the importance of having in place an appropriate framework for inter-state cooperation.[7]

The nation state remains the key actor on the international arena, but national sovereignty is increasingly being undermined or challenged by integration and interdependence. Nation states must find ways to manage their interdependence and pursue their common interests. One way to aim for this is through voluntary intergovernmental cooperation, as is largely the case with, for instance, the UN and the Bretton Woods institutions (the IMF and the World Bank). Alternatively, effective cooperation may be sought through a common construction to which member states confer supranational powers. The key characteristic of the EU, from its very beginning, has been the importance accorded to supranational action (and shared sovereignty) relative to traditional forms of intergovernmental cooperation. The transfer of sovereignty from the national to the EU level may be rationalised with arguments quite analogous to those employed in the contract-theoretical approach to the origin and justification of the state (see Chapter 2).

The date of birth of the Community is 9 May 1950, the date when Robert Schuman announced the plan, conceived by Jean Monnet, to bring the coal and steel industries of France and Germany under a single joint authority with supranational powers (to be seen as 'a first step in the federation of Europe'). The European Coal and Steel Community (ECSC) was intended to make war between France and Germany 'not merely unthinkable but materially impossible', being clearly an economic construction set up for basically political purposes.[8] It was created in 1951 through the treaty of Paris by the same member states (Italy and Benelux in addition to France and Germany) that in 1957, through the treaty of Rome, also created the European Economic Community (EEC). The core of the project was to use economic and political integration as a mechanism to prevent any possibility of resurgence of hostility between France and Germany, as well as to pursue postwar economic construction and enhance security in the face of the threats posed by the Cold War. The Rome treaty may also be seen as a Franco-German deal in which France got access to German agricultural markets in exchange for opening up its markets to German industrial exports. The remit of the EEC was wide and included a common agricultural policy as well as a customs union and a single market.

Progress of the EU was timid for decades, but the single market was given a strong impetus by the Single European Act (SEA) in 1986, which generalised qualified majority voting and set a five-year deadline for agreement on the main decisions to accomplish the internal market by 1992 through abolition of remaining physical, fiscal and technical barriers. It also made economic and monetary union (EMU) an objective of the European Community (as it was then called) and strengthened the role of cohesion policies and structural funds.

A further leap forward took place with the adoption of the 'Treaty on European Union' in Maastricht in 1992. It included a blueprint and a timetable for EMU, which was subsequently followed to the effect that stage 3 of EMU could start on 1 January 1999 with eleven members (and Greece joining one year later). It laid the foundation for a common foreign and security policy (CFSP) and extended EU responsibility to new areas such as consumer protection, public health policy, transport, education and social policy. The subsequent treaty of Amsterdam (1997) mainly enhanced the role of the EU in the areas of justice and home affairs, while the Nice treaty (2001) provided some of the institutional adjustment needed with a view to the considerable enlargment of the EU to the east. The intergovernmental conference (based on the work of the European Convention chaired by President Valéry Giscard d'Estaing) has consolidated the basis of the powers of the EU into a 'constitutional treaty' and strengthened the policy-shaping role of the Council. If ratified, it also gives the EU increased competence in the area of justice and internal affairs (immigration and cross-border crime).

The roots of the EU lie in the traumatic war experiences and the determination of the original member states to organise their mutual relations in a way which prevents future wars. The founding fathers saw the EU as a peace project and it was this that gave them the motivation and courage to go beyond ordinary intergovernmental cooperation and opt for a supranational structure. For some of the later adherents – notably Greece, Spain and Portugal – EU membership has somewhat similarily been associated with significant historical experiences and fundamental values: the EU has for these countries been a guarantee of the irreversibility of the abolition of dictatorship and the establishment of democracy. For Finland and Austria, as well as for the ten new member states, EU membership signifies a new geopolitical identity and a belated reconciliation and reintegration of east and west.

One may conceive of the EU as a technocratic structure set up to manage cross-border externalities; this is not wrong but it misses the point. The EU can be understood only in the light of its association with the commitment to peace and democracy and the particular historical experiences surrounding its origin and enlargement. On the other hand, peace and democracy are today widely taken for granted in Europe, at least in the EU, and the historical foundation correspondingly plays less of a role. This means that other interdependencies and common interests must be seen as increasingly important in defining the *raison d'être* of the EU and for underpinning its legitimacy. Otherwise, there is a danger that member states lose sight of the rationale for common action, with negative consequences for the importance attached to the EU and for its capacity to act.

The EU is now half a century old. During this period it has experienced a spectacular widening of the scope of its activities as well as a significant deepening of integration. In parallel to the widening and deepening of the activities of the EU, its membership has expanded from six to twenty-five states. Membership of the EU now almost corresponds to the territory of Europe as a geographical entity. While causality may be open to interpretation, it is a fact that the period of the existence of the EU coincides with the longest spell of uninterrupted peace in the recorded history of Europe as well as with an unprecedented period of economic prosperity.

1.2.2 The EU defined

Some phenomena are like elephants – difficult to define but easy to recognise. This is not the case with the EU; it is too complex to be easily characterised and different observers tend to perceive it quite differently. It has been suggested that the EU is like a marriage in the sense of involving important rights and obligations and in being based not only on economic considerations but also on solidarity between the participants (but surely the EU is a marriage based more on reason than on love). Another popular metaphor is the suggestion that the EU is like a bicycle – it needs to be continuously moving ahead in order to be viable or successful. (However, while it is undeniable that the EU has been deepening and widening, one may argue that it has also converged institutionally towards a relatively stable configuration.) For Jean-Claude Trichet (2003: 6), the EU is like 'an impressive sailing ship with strong masts and many sails' set on a clear course and with the mission to achieve 'prosperity, peace and stability for the citizens of Europe'. (Or is it more like a fleet of ships, in troubled waters and with an unknown destination?) The metaphors are imaginative but not all that illuminating; they illustrate that the EU is *sui generis*, something new and historically unique, which defies easy classification.

This section will attempt a definition of the EU on the basis of features which seem noteworthy in general as well as in the economic area; the proposed definition is as follows:

> *Box 1.2* The EU defined
>
> The European Union, based on a community of values, is a system of governance for pursuing the common interests of European states and citizens, through integration by common policies and coordination of policies, within a framework of common institutions, upon which member states have conferred supranational powers in the treaties.

The definition may be longer than necessary; it might suffice to say that the EU is an instrument for pursuing common European interests, basically by supranational means. However, the longer definition is useful in pointing to several aspects of the EU which need to be commented upon: first, the EU rests on *shared values* based on its culture and history. The European identity may be difficult to define, and diversity may even be one of its characteristics, but it exists and the EU is itself an expression for it. The heritage of European civilisation and its common history include classical antiquity, Christianity and the Enlightenment as well as many ideologies and innumerable wars, including the two world wars. The common *Weltanschauung* includes values like freedom, human rights and democracy (increasingly embraced in much of the world) as well as the market economy and the welfare state.

Second, the EU is basically a *means* to an end, an instrument in the form of a system of governance to help pursue *common interests*. Paramount among these is the preservation of peace, but there are also many other common interests which can be pursued effectively only through cooperation. The EU may be seen as a project (or as a combination of projects) for, *inter alia*, strengthening the European economy and its competitiveness, defending the European social model and the welfare state, enhancing environmental considerations in Europe and globally, or ensuring a global political role for Europe. It is indeed one of the defining characteristics of the EU (in comparison with mere international organisations) that its activities are wide-ranging and cover, in one way or another, almost all areas of societal interest.

Third, the EU has a double character: it has so far been an entity composed of *states*, but it also has the vocation to be a union of peoples or *citizen*s. It is important from this point of view that citizens have well-defined rights (including but not restricted to the charter of fundamental rights). In particular, Community legal norms are to be regarded as 'the law of the land' in member states, and may be invoked by individuals before their state courts (in accordance with 'the doctrine of direct effect'). Also, citizens can influence EU decision-making through their voting for members of the European Parliament. In practice, however, it is the member states, as represented by their governments, which have been and remain the key actors in the EU.

Fourth, actions in the EU have a double character: they may take a form close to that of intergovernmental cooperation or coordination, but they are also in the form of *common action*. The latter is of supranational character, and includes both Community legislation and the exercise of power delegated to specific Community institutions, such as in the area of competition policy to the Commission or in monetary policy to the European Central Bank (ECB). The policies mainly work through enhancing *integration*, including through lowering or eliminating barriers to cross-border mobility ('negative integration') and through coordinating or harmonising policies ('positive integration').

Fifth, action in the EU is backed up by *common institutions* with significant supranational powers. The most important institutions are the Council (including the European Council), the Commission and the European Parliament. The support of permanent institutions enhances continuity and effectiveness of action. Needless to say, the articulation of the relations between the institutions is of great importance. As will be seen (in Chapter 4), these relations differ according to the method of action at the Community level. The allocation of roles in the EU is not easily comparable to the separation of powers at national level (along the lines delineated originally by Montesquieu), as the EU necessarily operates with a two- or multi-level structure (yet is not a federation).

Sixth, the EU is competent only to the extent that power has been conferred on it by member states in the *treaties* (or in the EU constitution if and when adopted and implemented). The EU has an existence and a life of its own, unlike simple fora for intergovernmental cooperation, but its limits and remits are defined by the member states.[9] By the same token, the EU is a legal-institutional construction which ensures the rule of law in international relations within the area, an important safeguard from the point of view of the small states.

Finally, it may be noted that the objectives of the EU (see Chapter 2) are rather vague and general; there is no pre-specified ultimate goal, no agreed '*finalité politique*'. On the contrary, the EU is an open construction in several senses. It is open to new members provided these fulfil certain criteria (such as democracy and human rights, including rights of minorities, and a viable market economy). Also, both the reality and the appropriate ambitions of the EU are contested issues; some perceive the EU as a bureaucratic monster constantly engaged in interventionist activity and therefore want to constrain its activism; others criticise it for amounting to nothing more than a framework for unfettered market competition and think it should assume greater responsibilities for Europe's future. The EU is shaped by multiple forces and its priorities will always, though often in complex ways, reflect the political objectives of its member states.

It was widely thought that the fundamental task of the European Convention, which finalised its work in June 2003, was to create a constitution for the EU (for adoption by the subsequent IGC). However, the results of the work of the Convention and the IGC (if subsequently ratified by member states), effectively amount to an intergovernmental treaty, even though it may be called a 'constitutional treaty'. Adoption of the treaty will not in itself change the constitutional character of the EU, though it may spell it out more clearly.

Perhaps paradoxically, it may at the same time be argued that the 'consitutionalisation' of the EU already took place long ago. Fundamental principles of the EU, introduced mainly through the case-law of the Court of Justice, include the principle of direct effect (see above) and the principle of legal primacy, according to which any Community legal norm (be it the treaty or secondary legislation) overrides national law. Other important principles include the fundamental rights, which may prevail over both national and (secondary) EU legislation, and the principle of effective remedies, which requires action to be be taken if the rights of citizens under EU law are violated (including, if need be, action against their own governments). These principles, in conjunction with the common institutions and the powers conferred on them, have already for some time given the EU a 'kind of' constitution, though this may not have been widely perceived (as it has happened by 'stealth' through judicial decisions rather than by political acts).[10]

An American Secretary of State (Madeleine Albright) once remarked that 'to understand the EU you need to be a genius or at least a Frenchman', while Michel Rocard has characterised the EU as a UPO (an unidentified political object). Certainly the EU is a complex and hybrid construction, balancing national and common interests by pooling sovereignty within an institutional framework with a particular split of executive and legislative powers. Also, the EU is both a technocratic structure and the manifestation of an idea or ideal. Jacques Delors, according to his '*triptyque*', considers that 'the EU is essentially about competition, cooperation and solidarity' (thereby referring to the internal market, the common policies and the structural funds). Critics claim, with some justification, that the EU is stronger on bureaucracy than on democratic accountability. Be that as it may, there can be no doubt that the EU basically is an institutionalised framework for managing interdependence and pursuing common interests with a view to safeguarding peace and prosperity. As such, it now forms an integral part of the system through which Europe is governed.

2
Rationale

Why should economic policy be a matter for deliberation at the EU level; why not leave it to member states? This chapter gives some answers to this important question by pointing to market failures and interdependence as justifications for government intervention and international policy cooperation with a view to enhancing common interests (section 1). Also, the chapter considers the subsidiarity principle (section 2), reviews the economic objectives of the EU as set out in the treaty (section 3), and interprets the EU and EMU as setting key parameters of an economic policy regime (section 4).

2.1 Interdependence and the common interest

It was argued above that the state and government may be perceived as an instrument or an agent, based on a social contract, set up to cater for those common interests of its citizens which cannot be left to private initiative and the market. From this it is no long step to conceiving of the need for a political authority to fulfil an analogous role in international relations. The idea that lasting peace in Europe can be achieved only through creating strong bonds between its nations indeed goes back several centuries. It has been given expression to, for instance, by William Penn (see Box 2.1) and Jean-Jacques Rousseau, who considered that the relation between the individual and the state may, from the point of view of security and liberty, be compared to that between a state and the confederation to which it belongs. Numerous political pamphlets have been published over the last centuries with a view to presenting reflections, plans and proposals for the integration of Europe as an alternative to its disintegration.[1]

Box 2.1 William Penn and peace in Europe

Influenced by the atrocities of the Thirty Years' War (1616–48), the English Quaker, William Penn (the founder of Pennsylvania), pleaded as follows in an essay on 'the present and future peace in Europe' published in 1693:

> Now if the sovereign princes of Europe, who represent that society, or independent state of men that was previous to the obligations of society, would, for the same reason that engaged men first into society, viz. love of peace and order, agree to meet by their stated deputies in a general diet, estates, or parliament, and there establish rules of justice for sovereign princes to observe one to another, and thus to meet yearly, or once in two or three years at the farthest, or as they shall cause, and to be styled, the sovereign or imperial diet, parliament or state of Europe; before which sovereign assembly, should be brought all differences depending between one sovereign and another, that cannot be made up by private embassies, before the sessions begin; and that if any of the sovereignties that constitute these imperial states shall refuse to submit their claim or pretensions to them, or to abide and perform the judgement thereof, and seek their remedy by arms, or delay their compliance beyond the time prefixed in their resolutions, all the other sovereignties, united as one strength, shall compel the submission and performance of the sentence, with damages to the suffering party, and charges to the sovereignties that obliged their submission; to be sure Europe would quietly obtain that so much desired and needed peace to her harassed inhabitants, no sovereign in Europe, having the power, and therefore cannot show the will to dispute the conclusion: and consequently, peace would be procured, and continued in Europe.

Penn also expressed views on practical issues such as the presidency function and (weighted) voting which bear a striking resemblence to actual arrangements in the EU. In fact, he was in favour of a rotating presidency, QMV with a 3/4 threshold, a language regime with Latin and French (the former for civilians, the latter for men of quality), and he considered that this Europe should eventually be inclusive, containing also the 'Turks and the Muscovites'. He even suggested a particular allocation of votes: Germany 12, France 10, Spain 10, Italy 8, England 6, Portugal 3, Sweden 4, Denmark 3, Poland 4, Venice 3, the Seven Provinces 4, others 3. Extracts of Penn's essay are reprinted in Salmon and Nicoll (1997: 3–5).

The two world wars of the last century may be seen as final confirmation of the view that Europe needs a supranational framework to contain the worst manifestations of nationalism. This was the perspective of the 'founding fathers', such as Jean Monnet and Robert Schuman. They considered that peace and prosperity in Europe call for constraints on national sovereignty and effective enforcement of binding rules (not unlike the case made by Thomas Hobbes and John

Locke to empower a sovereign with a view to preventing a state of civil war). However, to overcome political obstacles, they took a markedly pragmatic approach; an often quoted statement of Schuman is that 'Europe will not be made all at once, or according to a single plan. It will be built through concrete achievements which first create a de facto solidarity.'

They thereby succeeded in initiating a process, including the negotiation of treaties and the setting up of permanent institutions, which has subsequently led to a cumulative strengthening and widening of the role of the Community. While law and order and external defence by and large remain national responsibilities (for the time being), the EU has nevertheless assumed a role of such importance that it may increasingly be seen as the belated realisation of the ancient dream of utopian or prophetic philosophers. The role of the EU, which is indeed based on a contract between the participating member states in the form of treaties, is to manage the consequences of interactions between European nations with a view to ensuring that their common interests are articulated and safeguarded. The EU does so by providing an institutional framework for intergovernmental cooperation as well as for sharing sovereignty and for taking supranational action in areas where voluntary cooperation is not enough.

The prisoners' dilemma, used above to illuminate the genesis of the state, is readily applicable (and has often been applied) to illustrate problems and conflicts in international relations. Assume, for instance, that two nations with a potential border dispute (such as Pakistan and India) choose between a high and a low level of military spending. The logic of the prisoners' dilemma predicts that both countries will choose a high level of military spending, even though both would obviously be better off by (both) choosing the opposite policy. The favourable option will be possible only through some credible mechanism of mutual commitment to non-aggression. Or consider countries choosing between free trade and protection (of sensitive sectors). Free trade is the best policy if all countries comply, but protection may be chosen in the hope of free riding or in the fear that others will anyway resort to protection. Again, cooperation of some sort is needed to improve the systemic outcome.

Interdependence is clearly a precondition for mutually beneficial cooperation or for there to be a case for Community action. This precondition is widely met in Europe. Indeed, economic integration is no new phenomenon; cross-border barriers were arguably less of a hindrance to trade and factor movements in the nineteenth century than during much of the twentieth, and recent decades have again witnessed a pervasive trend towards integration in many sectors. Economic interdependence is now highly significant both within Europe and beyond ('globalisation'). It follows that stabilisation policies, tax systems, government-spending programmes and regulations should not be discussed and decided upon without due regard to their cross-border consequences. There is a pervasive case for international policy cooperation and, on the face of it, the case for policy cooperation is very general in the sense that interdependence always seems to imply a potential for mutually beneficial cooperation (see Box 2.2).

Box 2.2 The case for policy cooperation

Assume that policy authorities in countries *A* and *B* control instruments X_A and X_B respectively (Figure 2.1). Assume further that the optimum outcome for country *i* $(i = A,B)$ is given by point Z_i (the 'bliss point') and that the loss of deviations is proportional to the distance from Z_i (as would be the case for quadratic loss functions).

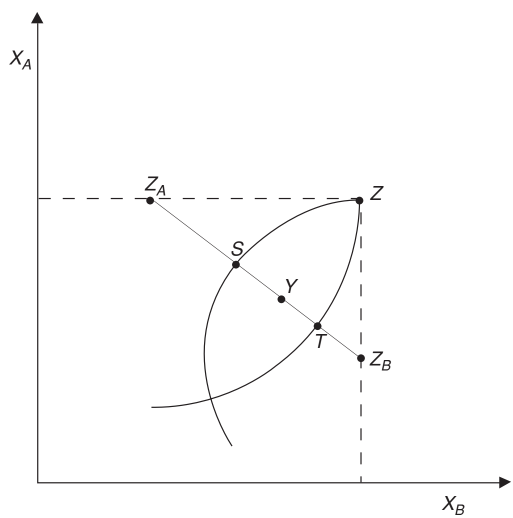

Figure 2.1 The case for policy cooperation

Acting on their own, each country will choose the value of X_i corresponding to its bliss point (because this will minimise the value of the loss function), implying that the non-cooperative solution is given by point *Z*. Both countries would be better off by agreeing an adjustment of their policies so as to bring them to some point, such as point *Y*, on the line between Z_A and Z_B in the segment between points *S* and *T*, as these points on the 'contract curve' would imply smaller deviations from both bliss points than the point *Z*. Note that all the points in the area between the curves are Pareto-superior as compared to point *Z*, and that the line between Z_A and Z_B is the set of all Pareto-optima. While the exact location between *S* and *T* (such as the one represented by point *Y*) would depend on the relative negotiation power, it should be possible for the authorities to cooperate so as to move from point *Z* to some point on the segment *ST* of the contract curve.

The problem of international cooperation might, from this perspective, be seen as one of identifying the set of solutions offering a mutual benefit, of negotiating with a view to coming to a particular choice within that set, and of ensuring appropriate enforcement of agreement. These problems might all be difficult to resolve if only voluntary cooperation is relied upon. Bargaining costs might be formidable, and it could be difficult to verify that each participant has taken the action necessary for proper enforcement, particularly so when many countries are involved. Effective cooperation might be possible only by countries making an agreement to shift some power to a common supranational institution, the method employed by the EU, but this is not easy to achieve politically. This way of presenting the issue gives the impression that there is a general case for policy cooperation in principle, though there may be difficulties of a practical or political character.

The practical and political difficulties of policy cooperation are certainly very important, and these will be a recurring theme in later chapters. However, it should be emphasised that the argument for policy cooperation as just set out is actually not all that convincing even at the level of principle (leaving aside the practical and political considerations). This is because the argument gives no rationale for economic policy in the first place; it only compares international cooperation to the lack of it. Such a comparison is relevant but it may lead to the conclusion that cooperation improves the outcome of policies for which there is no rationale in the first place. Arguably such policies should simply be discontinued (though if this is not an option, then cooperation is desirable in a conditional sense). The only policy cooperation needed might be action to eliminate barriers to cross-border mobility ('negative integration') with a view to achieving free competition on large and well-integrated markets.

A broader and more appropriate way to approach the issue is to pose the double question of whether there is a rationale for policy intervention as well as a case for policy cooperation. From this perspective it emerges immediately that the mere existence of interdependence in itself does not make international cooperation necessary; in particular, the coordination function may be performed by the hidden hand of atomistic markets. Action will certainly be called for to enhance free trade and factor mobility with a view to allowing the market mechanism to function. However, policies going beyond that need to be justified by pointing to specific reasons or problems that call for interventions by authorities. As seen in the preceding chapter, there are indeed circumstances, referred to as 'market failures', in which decentralised decisions give rise to problems and in which policy interventions may be justified. This section makes the additional point that many of the market failures reviewed above may have an international dimension, thus raising the question about the appropriate level of decision-making and potentially justifying policy cooperation or common action at the international level.

The question at hand is an instance of the more general issue concerning the proper assignment of competence for economic policy decisions in an entity with several layers or levels of government, an issue which is the subject of the theory of 'fiscal federalism'. While the EU is not a federation (though having some of its features), this theory may be drawn upon to make several observations on the international aspects of the market failures already reviewed above.

Public goods tend to be undersupplied in the absence of collective decision-making, and there is no reason why national boundaries should coincide with the area relevant for public goods. A legal framework and policies to support a well-functioning market economy are needed not only nationally but globally, and particularly so within a highly integrated economic area such as the EU. Open trading and financial systems will be properly provided for only if they are backed up by common action and strong institutions. The single market, with its rules and enforcement mechanisms, is indeed a main achievement of the EU. Yet much remains to be done in the area of services, where national regulatory barriers are still significant (financial services, public utilities, transportation). There is also an ongoing debate between those advocating centralised EU regulation and those in favour of 'mutual recognition' as the best way towards a well-functioning market in services (see Chapter 7).

The case for centralised provision applies to many public goods, notably those which are associated with large cross-border effects and large economies of scale (see also Chapter 9). For instance, close cooperation and common action in matters of law enforcement, border controls, immigration policy, aspects of foreign policy and external defence

Table 2.1 Rationale of policy cooperation

Provide international public goods
Manage cross-border externalities
Exploit scale and network effects
Achieve international redistribution
Improve macroeconomic stability
Strengthen international influence
Avoid 'harmful' policy competition
Enhance deeper political integration

may (for closely allied countries such as the member states of the EU) be a rational and cost-effective solution. Equally important, however, is that decentralisation makes it easier to cope with heterogeneity of preferences and to exploit local information. There is therefore a trade-off between advantages of centralisation and scale on one hand, and benefits of decentralisation and quality of information on the other. Also, the scope for joint supply of public goods is often restricted not by technical constraints but by political considerations as many public goods (like external defence) are key expressions of national sovereignty.

As noted above, action may in some cases give rise to *externalities* whereby part of the costs or benefits of decisions made by one economic agent accrues to others. These effects may well be cross-border externalities, as in the case of many environmental effects. The (positive) externalities of basic research and development activities may also extend beyond national boundaries and justify cooperative action. There is no doubt that cross-border externalities are the source of important common interests in the EU, justifying Community action and some coordination of national policies.

Scale and network effects may be of such importance as to call for international action, notably in the case of infrastructures extending across national borders. The trans-European networks (TENs) and the activity of the European Investment Bank (EIB) are cases in point in the EU context. They aim to facilitate the implementation of large cross-border projects with high added value in socioeconomic terms though low financial returns (or with highly frontloaded costs while returns materialise only in a very distant future).

Some *redistribution* takes place through the EU budget (structural and cohesion funds) with a view to reducing the income gap between more wealthy and less advanced member states or regions. However, social cohesion and income redistributions are much more important within states than in the EU. European citizens accept common policies decided by a majority only with difficulty; to do so in areas where redistribution is central meets with pronounced political hesitation or resistance. Also, on grounds of subsidiarity it may be argued that distribution within member states, even if one accepts redistribution between relatively rich and poor member states, should be a matter for national authorities rather than for regional programmes agreed at the EU level.

Concern about *macroeconomic stability* may call for either centralised or decentralised action. Domestic developments often have cross-border effects on overall activity levels and prices as well as on interest rates and/or exchange rates. Policy cooperation may be needed to avoid ‘free rider’ and ‘beggar thy neighbour’ behaviour. Macroeconomic stability, like free markets, is an international public good which is undersupplied in the absence of international cooperation. On the other hand, country-specific shocks call for national stabilisation policies. The EU has reconciled these conflicting requirements by setting up a rules-based system for fiscal policies within the framework of a monetary union. The assignment of stabilisation policies is analysed in Chapter 6.

It may be noted that cross-border spillovers often extend far beyond Europe and the EU. As pointed out by Musgrave and Musgrave (2003), ‘Truly global public goods stand at the end of a chain stretching from local street cleaning to national defence and environment protection to global warming.’ It is reasonable to foresee that the issue of global public goods becomes increasingly pressing as globalisation proceeds. Yet, the political frameworks for dealing with public goods exist so far only at the national and, to some extent, at the European level.

National economies have relatively well-developed mechanisms to deal with the problems of externalities, public goods, large-scale infrastructures as well as stabilisation policies and income redistribution. For instance, externalities can be internalised through taxes and subsidies, or controlled through regulation. Public goods can be supplied by tax-financed public programmes managed by specific agencies. Central banks can be assigned the task to ensure price stability, and redistribution of income can be achieved through government budgets. Comparable institutional mechanisms do not exist at the international level: while there are international agreements and institutions in some areas (like the Bretton Woods institutions), they are generally insufficient to deal effectively or comprehensively with the problems of allocation, stabilisation and distribution. The EU is unique in that it is an ambitious construction which aims at meeting the challenges for cooperation and common action on a broad scale, though primarily at a European rather than a global level.

There are at least three further considerations, over and above those reviewed so far, which may be advanced in favour of policy action at the EU level. First, member states may strengthen their collective *international influence* by coordinating their position within the Union. Individual European countries are too small to be able to pursue their interests effectively in, for example, international trade negotiations. Mandating the Commission to negotiate on behalf of member states makes the EU a powerful actor on the global stage. Similarly, the euro area may aspire to acquire enhanced influence on the international scene, in the G7 and in the IMF, if its members agree on common views and to 'speak with one voice'. The EU may help its member states to have political influence on the process of globalisation.

Second, action at the EU level may, in certain cases, aim at *restraining competition* or limiting the effects of competitive forces so as to protect national welfare and income redistribution systems. This is the case for policies aimed at limiting phenomena like 'social dumping' or a 'race to the bottom' and 'harmful tax competition' (see Chapters 7 and 8). For instance, minimum social standards may be defined as a safeguard against downward pressures that could otherwise come into conflict with the broad acceptance of a high level of social protection. Also, integration and factor mobility is often argued to give rise to excessive tax competition between countries, with harmful consequences for employment and for the financing of the welfare state.

Third, economic integration and cooperation may pave the way for *political integration*. Steps to facilitate trade and other cross-border activities strengthen the case for more political cooperation to reflect and take into account this interdependence. Seemingly practical or pragmatic decisions on economic issues may be viewed as part of a grand design based on a functionalist vision with a federation of 'the United States of Europe' as the final goal of the integration project. The EU started out as something as mundane as a community for administering the markets for coal and steel, but the idea of functional spillovers from the economy to politics was certainly not alien to the 'founding fathers' of the Community. This functional perception continues to be an important fear or hope depending on the view one takes of the desirability of a development of the EU towards an 'ever closer union' in political matters (notably foreign policy and defence). Needless to say, this line of argument goes well beyond economics.

Thus, cooperation and common action should, in a world of interdependence, yield mutual benefits by supporting better-functioning markets and cooperative action to tackle international market failures, as well as by helping to manage problems related to other cross-border effects. However, in their endeavour to safeguard their common interests, the EU and its member states need to answer three fundamental questions:

(1) When are policy actions called for, rather than leaving matters to the markets?
(2) What is the appropriate level for deliberations and decision-making: the EU or member states?
(3) What is the appropriate method or mechanism for EU decision-making (if called for): intergovernmental cooperation or supranational action?

The answer to the first question hinges on arguments about allocation, stabilisation and distribution that are familiar from the literature on public economics (see Chapter 1). The anwer to the second question depends on the scope and strength of cross-border effects as discussed above. The third question raises issues of the relative effectiveness of voluntary cooperation as compared to common or supranational action, an issue to be dealt with in Chapter 3.

2.2 Subsidiarity

A review of potential market failures and other arguments may give the impression that there is ample justification for all kinds of action at the EU level. This is not the case. In particular, there is at best a dubious case for the policies on which most of the EU budget is spent, the common agricultural and regional policies. These policies actually seem to have been initiated as side payments within broad political agreements on other common policies with much stronger rationale (the internal market and EMU). Neither is it clear that there are cross-border spillovers that explain why the EU should be issuing guidelines and recommendations on, for instance, the employment or social policies of its member states. Arguably this reflects the combination of an understandable political wish to pursue (and be seen as pursuing) worthy objectives with all means, and an optimistic view of the extent to which the EU can help its member states achieve structural reforms. While doing too much in some areas, the EU is doing too little in others. From an economic perspective it would certainly make sense for the EU to have a larger role in the provision of, for instance, internal security and external defence.[2]

However, it should not be taken for granted that economic policy cooperation or common action has only, or mainly, beneficial effects even in cases where the arguments for such policies are strong in principle. Practical difficulties may lead to inappropriate implementation. Policy actions deemed desirable *ex ante* may turn out to be failures *ex post* because of unforeseen events. Also, political difficulties may prevent the exploitation of opportunities for beneficial cooperation or may lead to 'government failure' in policy-making. Cooperation at the EU level may be initiated to demonstrate that a particular issue is given high political priority, even if there were no obvious cross-border externalities at stake. Officials may be inclined to develop coordination procedures (with many meetings and reports) to underline their own importance and to use the EU as an arena for pursuing specific or sectoral interests. Policy cooperation, like economic policies in general, is not always a rational response to well-identified problems. Cooperation reflects a multitude of diverse influences, some of which have negative effects on its modalities and its effectiveness, and policy cooperation should therefore always be subject to critical examination (see Chapter 10).

It is for reasons such as these that the treaties give prominence to the principle of subsidiarity, which foresees that decisions should be taken at the national (or local) level unless there is a strong and specific case for Community action; that is, 'unless the objectives of the proposed action cannot be sufficiently achieved by the Member States' and can 'be better achieved by the Community' (Article 5). The principle of proportionality complements this presumption by limiting Community action so as not to 'go beyond what is necessary to achieve the objectives' (same article). The principles of subsidiarity and proportionality reflect the view that the case for policy cooperation may be weak in practice even if strong in principle. Reasons for this include the fact that the information set used for decision-making may be better at the local and national level than in EU decision-making, and that it may be easier to ensure accountability and to rectify errors if decisions are taken at a level close to those affected by them.[3] In essence, subsidiarity amounts to a presumption in favour of decentralisation as a key principle in the economic constitution of an entity with multilevel governance.

2.3 Economic objectives in the treaty

The tasks of the Community, as set out in Article 2 of the EC treaty, include the promotion of 'a harmonious, balanced and sustainable development of economic activities' and 'the raising of the standard of living and the quality of life' as well as 'economic and social cohesion and solidarity between Member States'. This statement of the overriding objectives of the EU is obviously broad and vague. It is reminiscent of the famous triad of policy objectives of economic textbooks, according to which the goals of economic policy are macroeconomic stability, allocative efficiency and distributional fairness.

The treaty is more precise with regard to the framework within which the objectives should be promoted. On the level of principle, the treaty gives expression to a rather clear attachment to a liberal economic doctrine with emphasis on free competition as well as monetary and financial stability. In Article 98 it is stated that 'the Member States and the Community shall act in accordance with the principle of an open market economy with free competition, favouring an efficient allocation of resources', and Article 4(3) requires 'compliance with the following principles: stable prices, sound public finances and monetary conditions and a sustainable balance of payments'. These principles, in combination with the articles on the independence of central banks and on the constraints of fiscal deficits and their financing, define key parameters of the economic policy regime.

As a practical matter, there can be no doubt that the main role of the Community in the area of economic policies, as envisaged in the treaty, is to set up a multilateral framework for competition and stability in the form of the internal market and monetary union (and it is remarkable that these key objectives have been achieved to a high degree). The economic rationale for the internal market is generally accepted on efficiency grounds, and it is also widely agreed that it can be established and safeguarded only by strong action at Community level. The case for the monetary union is a more complicated issue, but it is again evident that a single currency is (almost) inconceivable without a common central bank with supranational powers. The view contained in the treaty amounts to saying that the Community needs to set up and uphold an integrated liberal economic order, and that this justifies common action to create the legal framework (and certain flanking policies) for the internal market and EMU.

2.4 The EU as an economic policy regime

The objectives set out in the treaty and the promotion of common interests, notably in conditions of high interdependence, call for bringing economic policies to EU level, while the subsidiarity principle amounts to a presumption for the opposite. However, there is a related and equally important question: should policies primarily or only be geared to safeguarding the conditions for free competition and monetary stability, or should they be more active and interventionist in orientation with a view to enhancing economic and political objectives in a more direct way?

There are two opposing views on this in the Union. One perspective underlines the potential for efficiency gains from unfettered competition as well as the virtues of budget discipline and monetary stability. The great advantage of the internal market is to eliminate cross-border barriers and to reduce the scope for interventionist policies, and it is similarly a chief attraction of EMU that it leaves less room for national policy activism in the macroeconomic area. This liberal perspective takes a positive view of the market mechanism and the competitive forces on the internal market, which should also help to stimulate supply-side policies in the form of deregulation or economic reform to strengthen incentives for agents to adapt to changing market conditions. It takes a sceptical view of policies to steer or complement the market, notably of discretionary policy activism (as compared to policy rules). It is a virtue of the EU and EMU that they leave little scope for interventionist action by politicians notoriously inclined to misguided activism.

The other and largely opposite perspective is that mutual interdependence has undermined the effectiveness of national policies. Given the high level of integration, individual governments are not in a position to steer markets effectively or to manage overall demand and growth. Only if policies are pursued at EU level will it be possible to set high political ambitions for growth and employment as well as for social developments and the environment. The virtue of the EU is that it creates the preconditions for common action and for effective coordination of policies. This should pave the way for 'politics to recover power over markets' and it could thereby help reconcile the social ambitions of the Community with the economic consequences of integration.

There is therefore debate about the appropriate 'mission' of the EU and fundamental disagreement as to which perspective is the 'right' one. As a matter of fact, since the 1980s the liberal perspective has been more in tune with dominant opinions among member states, and it is more in line with the text of the treaty. No doubt many see this as a main advantage of the Community. Dissidents from this view fall into two categories.

(1) Some do not accept the characterisation and argue that the EU and the EMU in reality pave the way for and are geared to supranational

interventionism, and that this is the reason why the EU and EMU should be rejected. On balance, this view (held notably by the British Tories) seems poorly justified. While the Community may on occasions engage in excessive regulation or harmonisation, there can be little doubt that the Community framework has greatly strengthened the role of the market mechanism in Europe in the past decades.

(2) Others agree the characterisation but wish the Community were more ambitious and active in steering and supplementing the market so as to enhance political and social objectives. Those holding such views include many in the mainstream but also those who call for the setting up of a '*gouvernement economique*' with substantial powers over taxation, spending and regulation.[4] (However, nobody has explained how such an EU government should achieve the needed legitimacy, how it would relate to national governments and parliaments, and how it could avoid getting bogged down in endless and fruitless quarrels.) Needless to say, discussion is bound to continue on the appropriate scope for policy discretion at both the national and the EU level with regard to the ways in which the common interests of member states should best be pursued.

3
Methods

The thrust of the preceding chapter is that integration and interdependence give rise to cross-border spillovers and common interests of member states. Economic policy decisions therefore need to be taken in a setting which goes beyond the purely national context. Voluntary cooperation may suffice if all actors have incentives to cooperate, while common or supranational action is called for when voluntary cooperation cannot evolve credibly. This chapter discusses, on the basis of public choice theory,[1] some of the difficulties and issues of principle in dealing with interdependence and the common interests through collective decision-making. It also illuminates the importance of agenda-setting and the strategic role that the Commission can play when it has the sole right of initiative and can thereby act as an agenda-setter for the Union. (The institutional modalities of EU decision-making are described in more detail in Chapter 4.)

3.1 Intergovernmental cooperation versus supranational action

The EU is of a distinctly supranational character. However, it also encompasses activities with a strongly intergovernmental flavour. The differences between the methods are fundamental, and there is an ongoing debate on the pros and cons of intergovernmental cooperation as compared to common or supranational action. Some of the main differences follow.

First, intergovernmental cooperation is voluntary and thereby implies no loss of national sovereignty. Supranational arrangements, by contrast, involve more than agreements on specific decisions. Like 'incomplete contracts', they necessitate delegation of some real discretionary power to the supranational level, and commitment to the acceptance of supranational decisions even if these might conflict with national interests. Some national sovereignty is ceded so as to achieve effective implementation of decisions and/or to gain influence on wider issues. Correspondingly, intergovernmental agreements normally become binding only if and when ratified through national procedures (e.g., by parliaments), while supranational decisions are directly binding (as is the case for EU regulations), or impose on the member states an obligation to make them legally binding through national transposition (as is the case for EU directives). Also, there are no sanctions for violations of intergovernmental agreements: such deals can be renounced, and withdrawal from intergovernmental arrangements is always an option. Supranational decision-making needs surveillance and possibly sanctions with a view to creating deterrents for violations of decisions, because the whole purpose of the arrangement is to achieve effective enforcement. There may be no general opt-out provisions nor recognised right of secession; exit is costly, even if possible.

Second, intergovernmental cooperation is about making deals on specific issues and may not require the setting up of any particular institutional arrangement. Supranational decision-making, by contrast, needs the backing of common institutions engaged in planning policies, decision-making, surveillance of developments, as well as judicial action to settle disputes caused by deviations of national action from agreed norms of behaviour. As noted above in Chapter 1, it is one of the distinctive features of the EU that its activities are backed up and shaped by common institutions with important tasks and competencies. The treaties assign certain competencies to the EU level and establish a Court of Justice, the rulings of which take precedence over national law.

It may be added that supranational bodies in the EU are of two varieties: those to which power has been delegated and over which governments retain no direct control (the Commission, the European Parliament, the Court of Justice and the European Central Bank), and those in which the governments jointly take the decisions as a consequence of 'pooling' sovereignty (the Council and the European Council). This distinction is important but one should not think of the former institutions as being supranational and the latter as intergovernmental; the Council is an eminently supranational body (taking, for example, most of its decisions by qualified majority).

Finally, intergovernmentalism is based on the unanimity principle, while supranational decision-making typically envisages the possibility of member states being outvoted within some system of majority voting. It should be underlined that the distinction between intergovernmental cooperation and supranational action is not the same as that between majority voting and unanimity; many decisions in the Community are taken by unanimity, yet are clearly supranational (being, *inter alia*, directly legally binding in member states). There is nevertheless a close connection between these issues, and the differences between majority voting (or qualified majority voting) and unanimity are of great interest and significance.

3.2 Collective choice with unanimity

The literature on public economics applies one main normative criterion for ranking outcomes with a view to decisions. This is the Pareto-optimum, which refers to any situation having the characteristic that it is not possible to improve the position of any one individual without worsening the position(s) of at least some others. It follows that a Pareto-improvement is favourable or at least acceptable to all. However, it will certainly very often be the case that particular policy actions improve the lot of some people while worsening that of others (as compared to no policy action). No unambiguous ranking of such alternatives is possible without interpersonal comparisons of gains and losses, which are difficult to make. This does not mean that redistributive policies are less desirable than actions leading to Pareto-improvements; society may, for good reasons, take the view that the lot of its poorest members should be improved at the cost of the rich. The point is only that economic policy actions may, in this perspective, be seen as falling into one of two categories: those that constitute Pareto-improvements or bring the economy to some Pareto-optimum, and those that do not because they affect various segments of society in different directions. The former decisions are essentially about efficiency, the latter relate to distribution and equity.

The unanimity requirement allows, in principle, only decisions that are Pareto-improvements. Such decisions should therefore be acceptable to all participants. One may indeed conceive of a wide area of policy decisions that fall into this category. As has been seen in the preceding chapters, many of the important decisions of the state and of the EU amount to the provision of public goods. A key feature of public goods is that they are potentially beneficial to everybody in a wide jurisdiction, and it is therefore conceivable that decisions on them could be taken by unanimity. Conversely, reliance on unanimity is a safeguard ensuring that only such decisions are taken which are of mutual benefit to all, without any risk of coercion of the minority by the majority.

Majority voting has important consequences for the way in which conflicts may be resolved, notably conflicts over distributional issues. This fundamental point may be illustrated as in Figure 3.1, which measures the outcome (in terms of 'utility' or 'welfare') of a group of countries *A* on the vertical axis and of a group of countries *B* on the horizontal axis. (Countries within each group are for simplicity assumed to be identical.)

Point *Z* shows a conceivable position in the absence of any cooperation between the countries. The countries may achieve some mutual benefits through intergovernmental cooperation, illustrated in the figure as a movement from point *Z* to point *Y* (corresponding to points *Z* and *Y* in Figure 2.1). Given that only voluntary cooperation is involved, the gains may be modest but all countries will gain, otherwise there would be no agreement on cooperation. Point *Y* must constitute a Pareto-improvement and therefore be northeast of point *Z* (to the right of and above the dotted lines from point *Z*). However,

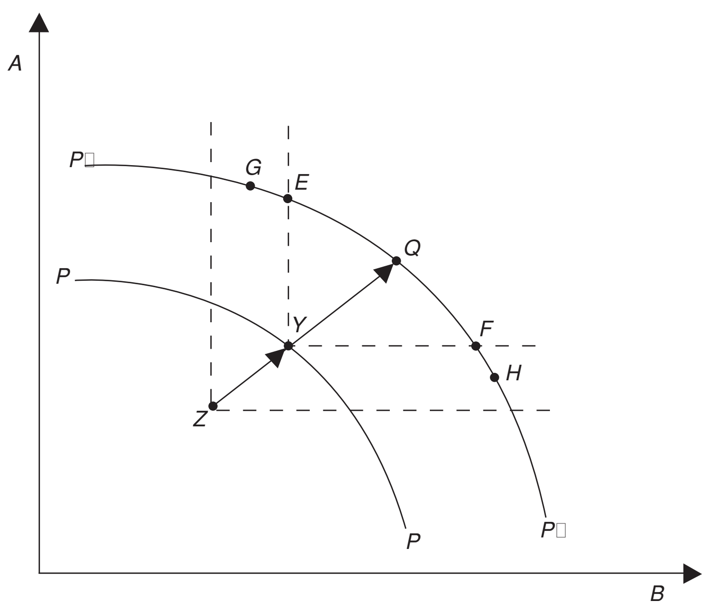

Figure 3.1 Majority voting and redistribution

the countries might also agree on common or supranational action with a view to, for instance, providing some public goods or to manage externalities, going beyond what could be agreed through mere intergovernmental cooperation. Supranational action may allow efficiency gains, making it possible to achieve a better outcome for all countries. This is illustrated as a shift of the locus of the (Pareto) efficient points from the curve *PP* to *P′P′* and a corresponding movement of the outcome from point *Y* to, say, point *Q*.

One might ask why countries should satisfy themselves with intergovernmental cooperation if there are indeed benefits which can be achieved only through supranational arrangements. The answer is that supranational arrangements inevitably imply substantial departures from unanimity in decision-making; otherwise the common policies constantly risk being paralysed by the difficulties of reaching unanimity (see below). This, however, means that the outcome on the curve *P′P′* (depending on which group of countries is in majority) could possibly be to the left of the line *ZE* (such as point *G*) or below the line *ZF* (such as point *H*). The outcome under supranational action as compared to intergovernmental cooperation could therefore amount to a worsening of the situation for some countries. For instance, assume that group *A* consists of relatively less affluent countries which are net beneficiaries from the Community budget, while group *B* are the net contributors. If in the majority, the net recipients might increase Community activity and tilt it into directions which serve to increase their income at the expense of the other member states.

Giving up national sovereignty raises the stakes: it increases the scope for mutual benefits through collective undertakings, but it also makes the position of each participant vulnerable to the outcome of decision-making processes over which it has only incomplete control because of substantial departures from the unanimity rule. This is problematic because supranational action to pursue common interests will inevitably have distributional consequences. Also, there is nothing strange in the hypothesis that EU member states will exploit any available institutional means for transferring income from their neighbours to themselves; this simply assumes that states are selfish or pursue the national interest. The prospect that a majority might use its power to exploit the minority is disturbing, even more so when the parties concerned are different countries rather than different segments in one country (cf. the views of Buchanan referred to in section 1.3). Safeguards are therefore needed to prevent politically unacceptable redistributions (see below) and, not surprisingly, the issue of the voting rules is invariably one of the most difficult in any intergovernmental conference discussing changes to the treaty.

The unanimity requirement still plays a big role in the EU, and the main reason for this is the concern, just outlined, that a majority of member states could otherwise impose highly conflictual outcomes on a minority. Also, most EU decisions can achieve their intended results only through a process of national implementation. As underlined by Wallace (2003), the prospects for rapid and effective implementation and satisfactory compliance are far better in a consensual (rather than majoritarian) procedure, which fosters a sense of ownership and respect for what has been decided. Nevertheless, in practice the requirement of unanimity raises great difficulties. These are of such an order of magnitude that the suggestion that all decisions should be on the basis of unanimity is of only academic interest. There are three major drawbacks of the unanimity requirement.

First, decision-making with unanimity takes a very long time, notably if the participants have heterogeneous preferences and therefore some conflicts of interest. Decision-making then requires a process of discussion, negotiation and compromise, often involving redefinitions of the issue under consideration. Given the requirement of unanimity, there is no way of achieving agreement on distributional conflicts ('sharing out the cake') except by imbedding them in a larger context so as to make possible an outcome that 'gives something to everybody'. The bargaining or 'transaction' costs become considerable and decision-making by unanimity is therefore particularly ill-suited to situations where speed of decision-making is essential. The outcome of lengthy negotiations is all too often a package reflecting the lowest common denominator, including bizarre elements of horse-trading, and delaying or suppressing decisions on important elements on which decisions are urgently needed but on which unanimity cannot be achieved. In fact, the unanimity requirement carries with it a big risk of paralysis (because almost any decision risks hurting somebody's interests).

Second, the unanimity requirement encourages strategic behaviour. Some actors are likely to start the bargaining process with wildly exaggerated claims with a view to creating scope for 'concessions' while still securing a satisfactory outcome. Also, participants may understate their preferences for public goods in attempts at free riding or so as to justify as small a participation as possible in the costs of collective undertakings. In international negotiations (as in poker games), honesty is a dubious strategy, and the lack of honest preference revelation tends to add to the time required and the complexity of negotiations.

Third, the unanimity requirement may create temptations for 'hostage-taking' (see Box 3.1). A country facing a big difficulty with regard to one particular issue may ask for this problem to be resolved to its satisfaction as a precondition for going along with a totally unrelated decision which is subject to the unanimity requirement. It therefore happens that negotiations aiming at unanimity for a particular decision escalate (or degenerate) into horse-trading over packages for which there is no logic other than the blackmailing tactics of some of the participants.

Box 3.1 Tax policy and milk quotas

Negotiations on the so-called tax package (see Chapter 8), which had been pursued for many years, came close to finalisation in the Ecofin Council in the spring of 2003. At that point the Italian government took everybody by surprise by linking the tax package to Italian milk quotas. (The point of this story is not that it involves Italy; this is coincidental and similar examples could be given for other member states.) Farmers in Italy had for years been producing milk in excess of their quotas (agreed in the Agriculture Council). According to the rules, they should have had to pay heavy fines. The Italian Government proposed to assume the financial burden itself and insisted that the Council should decide that this shall not be considered state aid to the farmers. The milk quota issue was important for the Italian Government for political reasons (farmers in northern Italy being of strategic significance for some of the parties and ministers in the coalition). Other member states, however, considered the Italian request outrageous as Italian farmers had clearly violated Community rules and were thereby creating a precedent undermining the Community's agricultural policies (in Italy as well as elsewhere).

Unanimity was needed both for the tax package and for a decision on milk quotas. In the run-up to the June European Council meeting, Italy insisted on a unanimous decision in its favour on milk quotas as a precondition for its acceptance of the tax package, while other member states flatly refused the request as inconceivable. The situation had some of the features of a 'game of chicken', a situation in which two players threaten each other with non-cooperation (and the prospect of disaster) with a view to pressuring the other player to give in. The confrontational attitudes paved the way for a clash in the European Council, where heads of state pursued a heated (and inconclusive) debate about the tax–milk link for one-and-a-half hours!

Subsequent to the European Council meeting, a package deal was agreed in the Ecofin Council, allowing the tax package to be adopted and giving satisfaction to Italy with regard to the milk quotas. This incident, which illustrates EU hostage-taking and horse-trading under conditions of unanimity, is regrettably far from unique.

3.3 Collective choice and majority voting

It is obvious that there are often circumstances in which unanimity is not a useful voting rule. As Buchanan and Tullock (1962) have suggested, there is a trade-off between two different costs of decision-making. On the one hand, a move from unanimity to (some degree of) majority voting increases the risk that decisions hurt the interests of the participants being part of the minority (as illustrated in Figure 3.1 above), thus giving rise to what Buchanan and Tullock refer to as 'external costs' of decision-making. On the other hand, relaxing the unanimity requirement in favour of majority voting reduces the time and procedural costs of bargaining: the 'decision costs', the more so the smaller the majority needed to pass a vote. Following Buchanan and Tullock, this trade-off may be set out as in Figure 3.2, where the (expected) costs of taking decisions are depicted as functions of the fraction needed to pass a vote.

The curve representing the external costs, given by *E*, is a declining function of the required majority (*M*) and converges to zero for unanimity, while the curve representing decision costs, given by *D*, is an increasing function of the required majority. The slopes of the curves have been assumed to be such that total costs have a minimum for

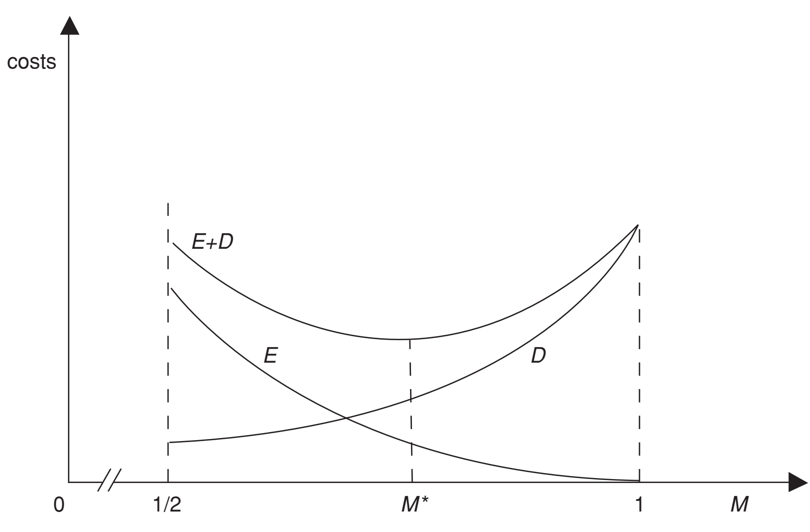

Figure 3.2 The optimal majority

$1/2 < M^* < 1$, where M^* is the 'optimum' majority which minimises the total costs of decisions. Obviously, the optimum required majority may be large (even unanimity) if the external costs are considerable, and it may be as small as simple majority if it is important that decisions are taken rapidly and lengthy negotiations avoided.[2]

This analysis assumes that the risk of external costs is the main drawback of majority voting. The risk is real enough: a majority will often be tempted to redefine an issue under consideration so as to increase its benefits at the cost of the minority even in cases where it would be possible to take a decision beneficial to all and which would therefore pass the unanimity test (see below). As seen above, the unanimity requirement safeguards the interests of every participant but tends to buttress the *status quo* and may lead to paralysis. The big advantage of majority voting is that it allows for decisions with a view to adapting to changing circumstances, and does so even in situations where there are conflicts of interest. Also, the simple fact that majority decisions may not be agreeable to all does not in itself discredit them, as the procedure has some democratic credentials. However, upon inspection it turns out that majority voting raises a number of difficulties which need to be elaborated upon (and which may help to explain the hesitant and reserved attitude of some EU member states as to its general applicability).

One problem is that majority voting allows 'logrolling' or a majority agreeing a bundling of issues such that decisions pass as part of a package deal even if none of the decisions would pass on its own. This might lead to 'bad' compromises which do not correspond to the 'general' interest. To see this, consider the projects *I* and *II* proposed to a decision-making body consisting of *A, B* and *C* as in Table 3.1, with the pay-offs of the projects as indicated in the table.

First, consider version *X* of the table and assume that the decision-makers *A, B* and *C* are considering projects *I* and *II* separately. Both

Table 3.1 Logrolling

		Version X			*Version Y*		
Projects		*I*	*II*	*I+II*	*I*	*II*	*I+II*
Voters	*A*	–6	–6	–12	–1	–1	–2
	B	2	–1	1	7	–1	6
	C	–1	2	1	–1	7	6
	Σ	–5	–5	–10	5	5	10

projects will then be voted down (only voter *B* being in favour of project *I* and voter *C* in favour of project *II*). This might be as well since the losses to voter *A* would in both cases be significant as compared to the modest gains for voters *B* and *C*. However, voters *B* and *C* might agree amongst themselves to link the two projects and vote in favour of both, in which case they will both have a majority backing. This will ensure a positive overall pay-off for voters *B* and *C* and a loss for voter *A*. Assuming that the gains are small and the loss (of voter *A*) considerable, one might conclude that such logrolling is against the common interest, and one might recall that this outcome would have been avoided if unanimity were required.

However, this need not be the case, as can be seen from version *Y* of the table, which differs from version *X* only in that it is assumed that the gains are larger and some of the losses smaller. The outcome is the same as before in the sense that both projects will fail to pass by majority voting if considered separately, but will be accepted if voters *B* and *C* strike a deal (*B* voting in favour of project *II* in exchange for *C* voting in favour of project *I*). But in this case one may argue that logrolling serves a useful purpose, compatible with overall interests, by making it possible to pass decisions with significant benefits for the majority and modest costs for the minority. The practice of making deals linking separate decisions (which is a distinctive feature of decision-making, not least in the EU) is not good or bad in itself, it all depends. Logrolling has the benefit of allowing, in an indirect way, for the strength of preferences to influence decision-making.

Critics of big government often point to cases where interest groups and political parties push for particular budget expenditure from which they stand to benefit disproportionately as compared to the taxes needed for financing. Such behaviour may indeed give rise to a bias towards budget expansion. Member states in the EU may similarly have an interest in forming coalitions with a view to expanding EU activities in particular areas of specific interest to them (for instance, agriculture or regional spending). However, logrolling cuts both ways; it may also allow deals between those concerned about the budget costs and therefore wanting to restrain the level of activities and expenses.

A more fundamental problem is the *ambiguity of collective choice*, the ambiguous relation between the preferences of the individual voters and the outcomes of the collective choice process. One may think that a decision-making body should be capable of coherent action in the sense of having a well-defined ordering of alternatives, based on and aggregating the preferences of the constituent members of the body, and that the voting of the body should lead to unambiguous outcomes. However, such a presumption is not well founded. It is, in fact, a well-known result of public choice theory that collective decision-making may be arbitrary in the sense that there is no stable ordering of the alternatives (see Box 3.2). It should be added that the problem is not specific to majority voting. The issue is more fundamental and concerns the whole concept of a collective preference ordering (or a 'social welfare function'). As demonstrated originally by Kenneth Arrow (1963) in his 'impossibility theorem', any collective decision process inevitably contradicts one or more of a set of reasonable and rather weak axioms that one would like to assume holding for such a process.[3] It is, in other words, not possible to

Box 3.2 Condorcet's paradox

The problem that majority voting may have arbitrary outcomes, also referred to as the voting paradox, was recognised more than two centuries ago by the mathematician and philosopher Marquis de Condorcet. The problem may be illustrated by Table 3.2, which sets out the preferences of voters *A, B* and *C* over the options *X, Y* and *Z*.

Table 3.2 The voting paradox

Voter	*Preferences*
A	$X > Y > Z$
B	$Y > Z > X$
C	$Z > X > Y$
Majority	$X > Y > Z > X$

Asking the decision-making body consisting of *A*, *B* and *C* to decide by majority between *X* and *Y* gives the result that *X* is preferred (by voters *A* and *C*), a choice between *Y* and *Z* results in *Y* winning (voters *A* and *B*), but a choice between *Z* and *X* would give *Z* winning (voters *B* and *C*). This violates the transitivity condition, according to which $X > Y > Z$ should imply $X > Z$. Also, it is easily found that the voting procedure is unstable, ending up in any result depending on the particular sequence of taking votes. This ambiguity is at first slightly perplexing, and there is a rich literature examining the conditions under which the paradox does or does not arise. A main finding is that the problem does not arise if all voters have single-peaked preferences and the issue under consideration can effectively be dealt with as a one-dimensional choice, in which case the outcome will correspond to the one preferred by the median voter, a result referred to as the 'median voter' theorem; see Mueller (1989).

establish a collective choice process, be it with unanimity or majority, satisfying certain appealing normative properties. The best one can say is that some voting rules are fair or democratic as procedures even though they cannot be demonstrated to ensure that the outcomes are 'good' in a normative sense.

Needless to say, the problems of voting arise because of differences in preferences and the conflicts of interest that these give rise to. To see this, consider voters *A*, *B* and *C* who are choosing between different options which may be characterised in the two dimensions *X* and *Y* as set out in Figure 3.3. Assume that preferences are such that voter *A* would ideally prefer the option indicated by point *A*, with the 'loss' of voter *A* being proportionate to the distance from point *A* (as would be the case for a quadratic loss function), while points *B* and *C* correspondingly represent the 'bliss points' of voters *B* and *C*. For instance, dimension *Y* might stand for market liberalisation and *X* for Community spending. Country *A* might be in favour of liberalisation in the expectation that it could better exploit its comparative advantage (linked to

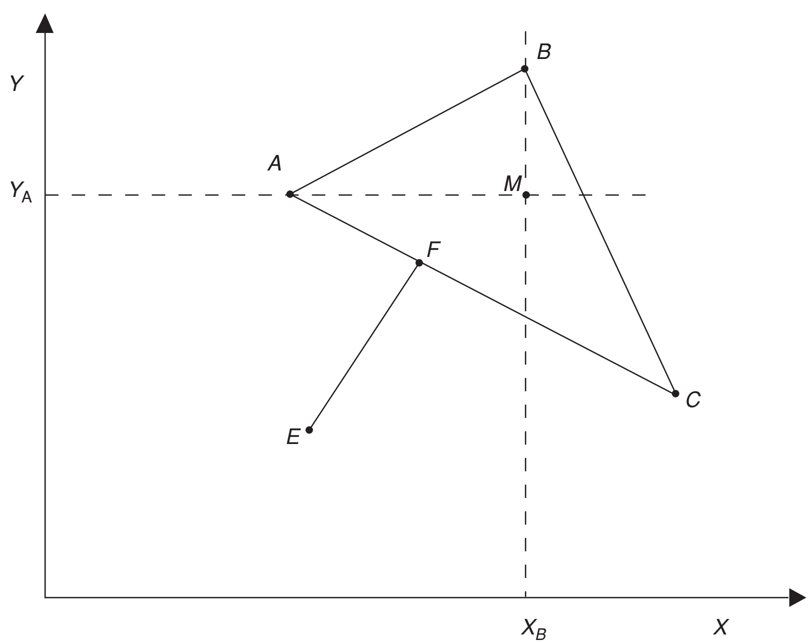

Figure 3.3 Sequential majority decisions

strong competitiveness). Country C might be in favour of Community spending in the expectation of benefiting from it substantially while bearing only a limited part of the costs, while country B could be in favour of both (in the expectation of benefiting from both liberalisation and more Community spending).

Assume further that the original location is as represented by point E. It is then obvious that the situation can be improved for all voters by moving to, say, point F. Such a decision could therefore be taken by unanimity. However, the area in the triangle delineated by points A, B and C constitutes the Pareto-set; no decisions changing the location within the triangle are possible by unanimity. To make choices within the Pareto-set, one has to resort to majority voting.

Consider first a specific procedure in which a majority decides sequentially rather than simultaneously on dimensions X and Y. It is straightforward to see that the median voter will be decisive for both choices: voter C will support voter B (the median voter in dimension X) in favour of setting X at X_B, because this is more favourable from the point of view of voter C than any outcome agreed between A and B. Similarly, Y will be set at Y_A (corresponding to the preferences of A, the median voter in dimension Y). Thus, the outcome under majority voting will unambiguously be at point M.

The result may seem reasonable but it is crucially dependent on the assumption that decisions on dimensions X and Y are taken separately. This effectively transforms the multidimensional choice into a sequence of unidimensional choices, the outcomes of which are each decided by the median voter. However, voters are usually reluctant to accept such a sequential approach, insisting instead that 'nothing is agreed until everything is agreed'; the various dimensions of the issue have to be considered simultaneously.

Consider next a situation in which a choice is to be made between the alternatives represented by points a, b and c (Figure 3.4), which are clearly tilted in favour of voters A, B and C respectively. Which one of these alternatives would be the result of majority voting?

To see that there is a risk for *instability* in this example, assume that the agenda-setter first pitches a against b. This leads to b being retained (by votes of B and C). Then b is pitched against c, which gives c winning (by votes of A and C). Finally, c is pitched against a, and this gives a winning (by votes of A and B). This just recapitulates the voting paradox already introduced above, and implies that the results of majority voting may be arbitrary and lead to a never-ending cycle without any stable outcome. This is not only problematic in itself but

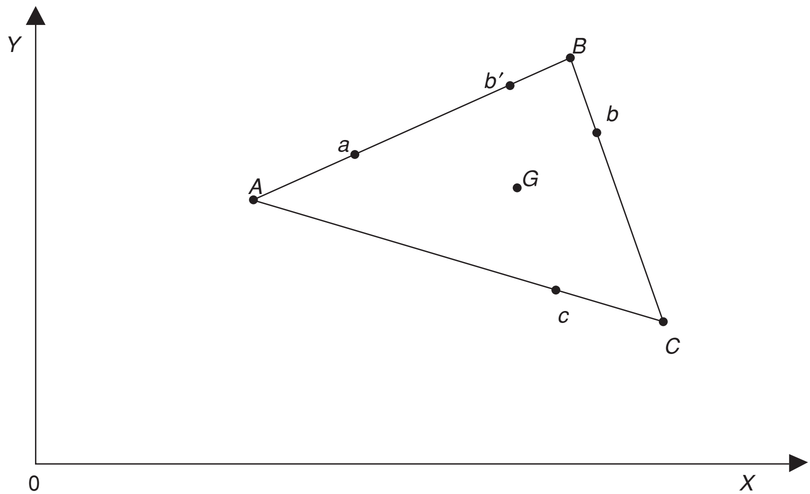

Figure 3.4 Problems of majority voting

also opens the way for *agenda manipulation*. Assume that only two votes are taken so as to decide the outcome. The preceding sequence would stop at the stage where outcome *c* is chosen. However, pitching first *b* against *c* and then *c* against *a* would give *a* winning, while the sequence *c* against *a* and *a* against *b* gives *b* as result. Thus, any alternative may win and the agenda-setter can *de facto* determine the outcome by choosing appropriately the sequence in which the votes are taken.[4] In the EU, the presidency can greatly influence how voting is organised. The possibilities of agenda manipulation illustrate that the role of the presidency can be important, even decisive, for the outcome.

Assume now that voting is not between some pre-specified options such as *a*, *b* and *c*, but rather that it is for the agenda-setter to specify one option to be pitched against the *status quo* in one single vote. Let the *status quo* be represented by point *b* and member state *A* be the agenda-setter. The best outcome that member state *A* can achieve is now represented by point *b′*, giving the same or a marginally better deal to member state *B* and giving no consideration to the consequences for member state *C*. This choice illustrates two principles of how to benefit from the power of agenda-setting: ‘winner takes all’ and ‘choose the cheapest coalition partners’. The former principle amounts to saying that one should maximise the gains of the majority, and that one should therefore make no concessions to the minority; to do so in order to get member state *C* into the majority coalition is pointless (as it is not needed to get a decision) and only a waste of resources.[5] The second principle means that the agenda-setter should design its proposal with a view to getting member state *B* as coalition partner, because the *status quo* is such as to make it less costly to maintain (or marginally improve) the position of member state *B* as compared to that of member state *C*.

3.4 QMV with safeguards

These examples are worrying in that they suggest the possibility not only of voting cycles, instability or arbitrary outcomes, but also indicate that the agenda-setter could (and rationally should) manipulate decision-making to its advantage at the expense of the minority. Several remedies may be suggested to alleviate these problems, and all of these play some role in the EU context:

- One might suggest sticking to *unanimity* for decisions in which the redistribution component is particularly important. This risks being conservative in locking in the *status quo*, but the *status quo* may be more acceptable than radical changes with significant distributional effects decided by majority voting. Some key decisions on the multiannual financial framework of the EU (the 'Financial Perspective') are in fact currently made by unanimity. Also, member states may agree to respect the 'Luxembourg compromise', which allows any member state to insist on unanimity if it considers that an 'essential national interest' is at stake, even if the decision is formally to be taken by qualified majority (though this is a political compromise and carries weight only to the extent that member states decide to stick to it).[6]
- It may be underlined that policies with redistributive implications should always be based on *general principles* rather than simply on the identity of member states. Such restrictions make it more difficult to use EU policies for the purpose of redistribution in favour of a particular country or group of countries. This corresponds to the view expounded by Buchanan, according to which 'the worst excesses of modern distributional policies' may be avoided by constitutional limits restricting majorities to voting taxing and spending laws that apply generally, or non-discriminatorily, over classes and groups in the political community.[7]

- *Rotation of the presidency* might introduce incentives for self-restraint on the part of the agenda-setter (as other member states may follow a tit-for-tat strategy), and any gains from the exploitation of the power of agenda-setting would at least be shared equally between member states. Also, presidencies might internalise a moral obligation to act as 'honest brokers' in the general interest. In fact, all member states might be induced to take a cooperative attitude because EU decision-making is typically a 'repeated game' between a restricted set of players (see section 1.1). It is indeed a striking feature of actual EU decision-making that presidencies often make great efforts to enlarge the majority even when the required majority has been achieved.
- Finally, one might set up a specific impartial institution for the purpose of managing the agenda and for acting as an 'honest broker'. In the EU this is the role of the *Commission*. In legal matters it normally has the sole right of initiative. Also, amendments to legal proposals of the Commission (against its will) can be passed only by unanimity in the Council. Thus, if the Commission were to propose a move from *E* to, say, somewhere in the middle of the Pareto-set (such as point *G*), this would become the outcome because at least one member state would oppose any change.[8] More generally, the Commission may play a crucial role for steering the decision process if it is able credibly to articulate and pursue the common European interests, and if member states have confidence in its impartiality. It is arguably the right of initiative of the Commission, in combination with the constitutional presumption in favour of its proposals, which is the most distinctive and innovative feature of the institutional framework of the EU.

The analysis in this chapter yields few simple conclusions but demonstrates that the relation between the preferences of individual decision-makers and the ranking of alternatives by the collective decision-making body is complex, may be unpredictable, is conditional on specific voting modalities, and does not necessarily fulfil any particular normative criteria. Voting rules should be such as to allow effective decision-making but should also give some protection to minorities. A reconciliation of conflicting requirements may be facilitated by assigning a special institution (the Commission) a strategic role in agenda-setting and arbitrage. In all, institutions and modalities matter, including those concerning voting rules and agenda-setting.

4
Modalities

The EU has become a veritable laboratory for common policies and policy coordination, and it now has a system of economic governance and an economic policy regime with a number of particular characteristics. The aim of this chapter is to shed light on this rather complex policy regime by answering the question ‘who does what and how?’ in the area of economic policy. The chapter first describes briefly the main Community institutions and bodies involved in economic policies (section 1). It then sets out the allocation of competences and the assignment of tasks (section 2) as a basis for distinguishing between different methods of Community involvement in economic policy-making (section 3). The chapter also describes voting rules (section 4) as well as the major instruments and procedures of economic policy coordination (section 5). Some details on the preparatory machinery and the decision-making procedures are to be found in the Annex to this chapter, pp. 67–70.

4.1 Community institutions and bodies

The institutional structure of the EU is complex and the respective roles of the main institutions may seem confusing, notably when compared to the familiar separation of powers at national level between legislative, executive and judicial powers. This section briefly describes the actors involved in economic policy at the Community level. It first characterises the respective roles of the main Community institutions or the ‘institutional triangle’ (the Commission, the Council and the European Parliament) and then makes some comments on the European Central Bank (ECB) and the Eurogroup.

4.1.1 The institutional triangle

The functioning of the Community rests on the interaction and balance between its three main institutions. Each of these has different tasks and powers as well as mechanisms of accountability.

(1) It is the task of the *Commission* to articulate, represent and promote the common European interest. It has the sole power to initiate legislation, and Commission proposals for legal acts can normally be changed (against its will) in the Council only by unanimity. Also, the Commission can withdraw its proposal at any time in the process. This means that the Commission has a right of veto on legal acts in the Council even though it has no vote. Once a law or a policy is adopted (after decisions by the Council and the European Parliament), the Commission is responsible for ensuring that it is implemented by member states; the Commission is the 'guardian of the treaties'. It also manages the EU's finances and acts as the EU's main external representative in dealings with some international organisations, such as the WTO.

The major decisions of the Commission are taken by the college of commissioners, chaired by the President of the Commission. Each commissioner is in charge of one or several directorates-general. These constitute the bureaucracy or administration of the Commission; they make analysis, develop proposals for new legislation and policies, manage Community programmes and monitor developments within the Union in relevant areas. The commissioners are appointed by their national governments, though in agreement with the President of the Commission. Yet, they are not national representatives and are expected to act for common European interests. The commissioners should be completely independent and the treaty insists that they 'shall neither seek nor take instructions from any Government or from any other body'. As initiator of new legislation and policies, the Commission has a political role; at the same time it constitutes the main technocratic apparatus at the Union's disposal. The Commission, being unambiguously a supranational body, is accountable to the European Parliament.

(2) The *European Parliament* is the only EU institution directly elected by EU citizens. It cannot initiate legislation (only the Commission can do this), it cannot decide legislation on its own (only in co-decision with the Council), and it cannot decide the taxes or revenues of the EU (only the member states can do this). Yet, the powers of the European Parliament have increased gradually and it now plays an important part in Community legislation and in decision-making on the annual budget. Also, the Euopean Parliament may, with a vote of two-thirds

majority, force the resignation of the Commission (as happened to the Santer Commission in 1999).

(3) The *Council of the European Union*, acting under the political guidance of the European Council, is primarily a decision-making body, increasingly acting in co-decision with the European Parliament. The Council consists of representatives at ministerial level of the governments of member states. It is chaired by a rotating presidency with wide-ranging responsibilities for the organisation of the work and representation of the Council. The treaties mostly refer to the Council in the singular, but the unicity of the Council is a legal fiction. In practice, the Council meets in different formations with different agendas according to the subject matter under consideration, and each Council formation has its own idiosyncracies with regard to the organisation and character of work. The main Council formation from the point of view of economic policy is clearly the *Ecofin Council*; that is, the Council meeting in the composition of ministers of economy or finance.

The Council is widely seen as the most important decision-making body in the Community. One may ask why power should reside with the Council rather than with the Commission or the European Parliament.[1] The answer must point to the existence of a fundamental tension between international interdependence on one hand, and the overwhelmingly domestic orientation of citizens' sentiments of identity, loyalty, and solidarity on the other. Decisions at the EU level may be justified by cross-border spillovers and common interests, yet are often perceived by citizens as unduly intrusive and as lacking legitimacy. From this point of view, it is important that member states are represented in the Council (and the European Council) by the same elected politicians that take decisions in the national context. This endows the Council with authority and helps give its exercise of power the legitimacy needed to reconcile the quest for national sovereignty with the reality of mutual dependence.

(4) The task of the *European Council* is to give overall political leadership to the Union, to set its priorities, to give impulses for further work and to ensure horizontal coordination (reconcile possible divergences of view between sectoral Council formations). It consists of the heads of state or government of the member states, accompanied by their foreign affairs ministers, and the president of the Commission, accompanied by a vice-president of the Commission. It meets at least four times a year and devotes an annual spring meeting to economic and social issues.

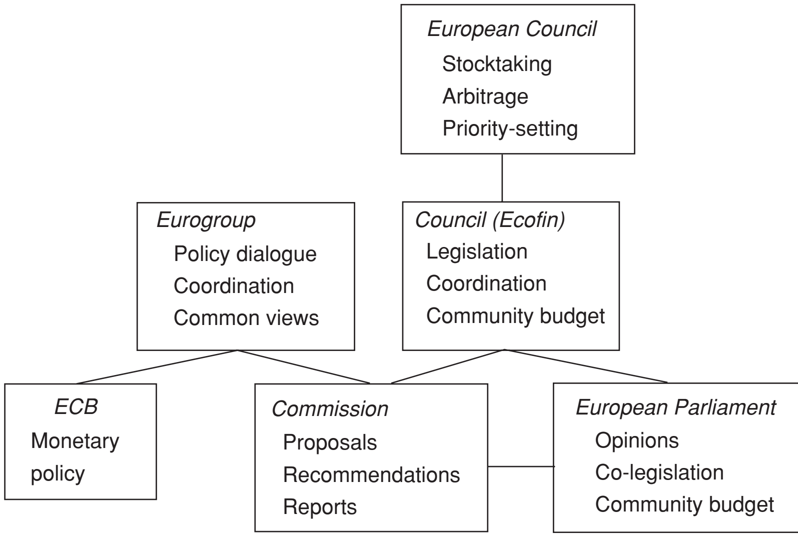

Figure 4.1 Economic policy in the EU: who does what?

4.1.2 Monetary institutions

There is widespread agreement on the significant benefits of price stability. First, it improves the transparency of the price mechanism and allows markets to allocate resources more efficiently. Second, it reduces inflation premia in interest rates and makes it less likely that individuals and firms will divert resources from productive uses in order to hedge against inflation. Third, it reduces the distortions associated with tax and social security systems (which are mostly not protected against inflation through indexation). Finally, it avoids the arbitrary redistribution of income and wealth that unanticipated changes in inflation give rise to. These considerations are reinforced by empirical evidence suggesting that economies with lower inflation grow, on average, more rapidly in the long run.[2]

It is for reasons such as these that since the 1980s, we have witnessed the emergence of a new consensus on the importance of a credible commitment of monetary authorities to price stability or low inflation as an anchor for inflationary expectations. As noted by Favero *et al.* (2000: 26), this 'requires that monetary policy be at arm's-length distance from short-term political pressures'; that is, that the central bank is independent and free to use monetary policy so as to maintain price stability. The monetary constitution of EMU reflects this consensus on the proper framework for monetary policy.

The *European Central Bank* (*ECB*) and the national central banks (NCBs) of the euro-area countries together constitute the 'Eurosystem', while the European System of Central Banks (ESCB) consists of the ECB and the NCBs of all EU member states. The main task of the ECB and the Eurosystem is to formulate and implement the monetary policy of the euro area. Other tasks include the conduct of foreign exchange operations, the holding and management of official foreign exchange reserves, and the promotion of the smooth operation of payment systems. Furthermore, the ECB has the sole right to authorise the issuance of banknotes in the euro area. Also, the ECB has an obligation to contribute to the smooth conduct of policies pursued by the authorities in charge of the prudential supervision of credit institutions and the stability of the financial system, but the ECB is not accorded any power to regulate or supervise financial institutions (unless the Council were unanimously so to decide).

The treaty stipulates that 'the primary objective of the ESCB shall be to maintain price stability' (Article 105). This is clear in principle but leaves plenty of room for discretion for the ECB. It is indeed a remarkable feature of the monetary constitution of the EMU that the ECB is 'goal-independent' in the sense that it is up to the bank itself to decide what price stability means without any role for a body with political responsibility. In practice, the Governing Council has defined price stability as an annual rate of increase of the harmonised consumer price index below (but close to) 2 per cent in the medium term.

The monetary policy strategy of the ECB is based on a two-pillar approach, the first pillar consisting of a reference rate for the growth of money (broadly defined), and the second pillar amounting to a comprehensive and forward-looking analysis of price developments in the light of various economic and financial indicators (including exchange rates and interest rates). Within this framework the practical decision-making of the Governing Council focuses on key short-term interest rates and associated operations in the interbank market. In special circumstances the ECB may also intervene in the foreign exchange markets with a view to reducing misalignments in the external value of the euro.

Box 4.1 ECB independence

The main decision-making body of the ECB is the Governing Council, which consists of the six members of the Executive Board and the governors of the central banks of the participating countries. The Governing Council takes all key decisions on the objectives, the strategy and the implementation of its monetary policy, while the Executive Board prepares the decisions by the Governing Council and oversees their implementation. The articles of the treaty and the statute of the bank (attached to the treaty as a protocol) stipulate that the ECB and the NCBs, as well as members of their decision-making bodies, are forbidden to seek or take instructions, be it from Community institutions or national governments. The independence of the ECB is further bolstered by the fact that the members of the decision-making bodies of the bank have long and non-renewable terms of office, and by the financial independence of the ECB. Also, the treaty forbids any provision of central bank credit to the public sector. As the safeguards of its independence are in the treaty, and can therefore be changed only in an intergovernmental conference with the consensus of all the member states, one may conclude that the ECB is institutionally highly independent, probably the most independent central bank in the world. As noted in Favero *et al.* (2000: xii), 'the chains of delegation and control from citizens to the Governing Council are long and complex, with no possibility of issuing instructions'. However, the ECB is accountable, in the sense of having reporting obligations, notably to the European Parliament.

4.1.3 The Eurogroup

The European Council in Luxembourg in 1997 decided to set up the *Eurogroup* as an informal grouping of the finance ministers of the euro-area countries, who meet regularly (mostly on the evening before the meeting of the Ecofin Council) to discuss matters of common interest and related to the single currency. The Commission and the ECB are invariably invited to these meetings, which have become the most important forum for dialogue on a number of issues such as the economic situation and outlook, including identifiable risks, budget developments within the euro area, the implementation of the fiscal policy rules, the macroeconomic policy mix and exchange-rate developments.

The Eurogroup, being an informal body, has no decision-making powers, these being reserved for the Ecofin Council. However, there are a number of issues on which only the countries participating in the euro area have a vote when decisions are taken in the Council, and discussions within the Eurogroup often predetermine the position that euro-area countries will take, notably in decisions on the implementation of the fiscal rules. A main purpose of the Eurogroup is to arrive at a common understanding of the economic situation, the risks and the challenges for policy action. Such a common understanding is an important precondition for peer pressure with a view to better coordination of the policies of member states. The Eurogroup occasionally issues communiqués on the economic situation or on policy issues, including on the external value of the euro.

There are a number of other EU institutions or bodies with particular functions. The most important of these is the European Court of Justice (ECJ), the task of which is to resolve disputes concerning the interpretation and implementation of Community law, including disputes on institutional issues and the allocation of competence. Other Community bodies include the Court of Auditors and the European Investment Bank (EIB).

4.2 Competence and assignment

Stipulations on competence and assignment are of fundamental importance and go a long way towards defining the 'hard core' of the EU policy framework. Competence refers to an actor being empowered, by a national constitution or by a treaty, to take decisions on the use of some instrument or set of instruments. Competence may be general or specific as well as exclusive or shared.[3] However, the allocation of competence over policies is not enough to define a policy regime; it is, as a minimum, also necessary to specify the objectives or assign the tasks that decision-makers should pursue. Also, it is helpful to identify systems of monitoring or surveillance giving rise to feedback from developments to policy planning.

The essential structure of the EU economic policy regime is as follows: *monetary policy is the competence of independent central banks and notably of the ECB in the euro area, while other economic policies remain the responsibility of governments of member states.* Also, the Treaty makes it clear that the primary objective of the ECB shall be to maintain price stability, and similarily for the independent NCBs in the case of the countries not participating in the euro area because of a derogation. Other economic policies, by contrast, can be used by member states to pursue objectives that they deem important. There are, however, a number of qualifications to the above:

- The ECB shall not focus exclusively on price stability but 'shall support the general economic policies in the Community with a view to contributing to the achievement of the objectives of the Community'. Nevertheless, the relation between the objectives may be seen as 'lexiographic' because the ECB shall support the general economic policies only to the extent that it can do so 'without prejudice to the objective of price stability' (with similar stipulations holding for the NCBs of countries outside the euro area).

- Member states are treaty bound to maintain sound public finances. The Excessive Deficit Procedure (EDP) and the Stability and Growth Pact (SGP) forbid 'excessive' government financial deficits and foresee early warnings, recommendations for action and the possibility of sanctions if this fiscal rule is not adhered to properly. This does not change the allocation of competence but implies a legal obligation of member states to comply with a specific constraint in the form of the fiscal rule agreed at the Community level (see section 4.5 below).
- There are a number of other 'quasi-constitutional' constraints in the treaty, notably concerning the ways in which national budget deficits may or may not be financed. These provisions support the independence of the central banks and the fiscal discipline of governments.
- There is Community competence in the area of the internal market (exclusive for much of competition policy and shared in other domains), and the economic policies of member states must comply with internal market legislation as well as competition and state aid rules (see Chapter 7).
- Member states shall take account of their interdependence and 'shall consider their economic policies as a matter of common concern and shall coordinate them within the Council'. In practice, this is predominantly done in the framework of the broad guidelines of economic policies (see next section). Such coordination shall be done 'with a view to contributing to the achievement of the objectives of the Community', 'in accordance with the principles of an open market economy with free competition' and 'in compliance with the principles of stable prices, sound public finances and monetary conditions and a sustainable balance of payments'. This guidance is not very precise but it underlines attachment to a free market economy and to financial discipline.
- There is a close link between monetary and exchange-rate policies. It is therefore of some importance that the responsibility for exchange-rate policy is shared between the ECB and the Council. However, the treaty (Article 111) is somewhat ambiguous with regard

to their respective roles. It is for the Council to conclude formal agreements on an exchange-rate system for the euro in relation to non-Community currencies, but this provision is, in foreseeable circumstances, of little practical relevance. The Council is also empowered to formulate 'general orientations for exchange-rate policy' in relation to third currencies, but such orientations 'shall be without prejudice to the primary objective of the ESCB to maintain price stability'. Presumably it is for the ECB to decide whether this condition is met (if it is to have real independence). Also, foreign exchange interventions, the instrument for giving effect to exchange-rate orientations, are in the hands of the ECB (Article 105). This suggests that exchange-rate orientations need the backing of both the Council and the ECB.[4]

The qualifications are of some importance but do not change the overall picture: monetary policy is run by the ECB (or independent NCBs) and geared to price stability, while member states are free to use other economic policies to enhance their own policy objectives, though subject to certain rules. This assignment of responsibilities is simple and clear. It is also markedly asymmetric, as the single monetary policy in the euro area is combined with nationally decentralised policies in other respects. EMU entails 'a currency without a state', and this feature is at the heart of much of the debate about economic policy coordination in EMU (see Chapter 6).

4.3 Methods of Community involvement in economic policy decision-making

It has so far been (implicitly) assumed that economic policy amounts to governance by the ECB and by national governments within a given legal framework. However, in a broader sense economic policy also encompasses legislative action; in some areas this is a main instrument of policy (notably in the case of the internal market). Also, action through the Community budget is one of the options for pursuing economic policies in the EU. It is, in fact, useful to make a distinction between four different methods of Community involvement in economic policy decision-making in the EU. These are as follows (for a summary comparison see Table 4.1):

(1) *Delegation of power to a supranational institution.* This is the method used for monetary policy. The treaty empowers the ECB to plan and implement monetary policy for the euro area (and, in conjunction with

national legislation, the NCBs to do so in the other countries). This delegation is accompanied by instructions, which assign the central bank the primary objective of maintaining price stability. However, the mandate is not overly precise as it is for the bank itself to define its strategy and to operationalise the meaning of price stability. Other examples of delegation of power to a supranational body are competition policy and state aid policies, where the Commission is empowered by the treaty to take the relevant decisions.

The legitimacy of delegation of power is based on three considerations. First, delegation is specific and related to the implementation of (relatively) well-defined tasks. Second, the decision on delegation has been taken in a manner (at an intergovernmental conference) which in itself has democratic anchoring. Third, there is accountability in the

Table 4.1 Economic policy in the EU: who does what?

Function	*Monetary policy (in the euro area)*	*(Other) economic policies*	*Legislative action*	*Community budget*
1. *Decisions* (competence)	ECB	Member states	Council+EP or member states	Council+EP
Qualifications	Objectives in treaty	Principles and rules in treaty	Depending on the treaty	Special rules in treaty + IIA
2. *Implementation*	ECB+NCB	Member states	member states	Commission + member states
3. *Monitoring + surveillance, dialogue + peer review*	ECB, EP, Eurogroup	Member states, Commission, Council and Eurogroup	Commission and/or member states	Commission, Council+EP, Court of Auditors
4. *Planning*	ECB	As above	Commission or member states	Commission
Overall	ECB	Member states	Commission + Council+EP or member states	Commission + Council+ EP
Method of Community involvement	Delegation	Coordination	'Community method' (legislation)	'Community method' (special rules)

form of reporting so as to allow evaluation of how the task is accomplished. Needless to say, legitimacy is enhanced if the delegated power is exercised with professional competence and good judgement.

(2) *The Community method or legislation*. The Community may enact legislation if there is a legal base in the treaty. This is the traditional and most important method for Community involvement in decision-making, and it is usually referred to as the 'Community method'. It involves a mutual interaction and a particular balance of power between the main Community institutions. The role of the Commission is to take the initiative and make a proposal (based on its analysis, consultations and planning). The Council and the European Parliament then deliberate and decide. The decision may be taken by the Council alone if the parliament only has a consultative role, while the two institutions will decide together in the case of co-decision. As noted above, amendments to a proposal require unanimity in the Council (unless the Commission agrees), and the Commission may withdraw its proposal at any time if it considers that modifications introduced in the Council or by the Parliament are unacceptable. Member states are responsible for the national implementation of EU legislation, and the Commission may initiate legal (infringement) procedures against a member state failing to implement or enforce EU legislation properly.

The Community method has a double legitimacy. First, Council decision-making amounts to a 'pooling of sovereignty', in which ministers and governments of member states jointly take decisions, and all governments are accountable domestically (though not separately for decisions taken in the Council). Second, decisions include and are binding on the European Parliament (notably in the case of co-decision), which is directly accountable to the European electorate.

(3) *Policy coordination*. This method is increasingly used to give the EU a role in areas in which the Community is not empowered to take decisions. Lack of competence does not exclude a role for the Community level in the policy process, understood as a sequence of planning, decision-taking, implementation and evaluation. In particular, the Community may in various ways be involved in coordination of the planning and evaluation of policies even if competence (power to take decisions) rests with member states. Such coordination may be 'strong' or 'weak'. The former refers to coordination based on legally binding rules, and is exemplified above all by the Excessive Deficit Procedure. Weak coordination activities (which have since increased or escalated) are quite diverse in terms of both subject matters and modalities. They include, *inter alia*, exchange of information, policy dialogue,

benchmarking and identification of 'good' or 'best' practices, the setting of common or national targets, monitoring and surveillance, and peer review within the framework of certain instruments and procedures (see section 4.3 below).

Coordination, notably in its weak form, does not pose a real issue of legitimacy as power over decisions rests with member states. However, there is a risk that policy coordination at Community level, particularly when it involves setting objectives, may create confusion as to the allocation of responsibilities for policy decisions. Also, the proliferation of coordination activities has become such as to call for streamlining to reduce the bureaucratic workload involved.

(4) *The Community budget*. Finally, policy actions may be undertaken by programmes in the Community budget (provided there is an appropriate legal base). Again, decision-making is by the Community method, though in a special version set out in the treaty and in an inter-institutional agreement (IIA) between the institutions, with considerable power for the European Parliament. However, the scope for policy action via the Community budget is limited as this amounts to no more than roughly 1 per cent of GDP in the EU. The agricultural and regional programmes of the Community are of considerable financial interest to certain member states, and the financial burden of the Community budget occasionally raises tensions between 'net payers' and 'net recipients', but basically the EU is a rule-making machine rather than an instrument for raising revenue for spending purposes.

The picture that emerges of EU decision-making is one of heterogeneity with regard to competence and diversity with regard to the method employed. Many actors are involved in the policy process, and there is a notable asymmetry in competence as between monetary policy and other economic policies. The methods of Community involvement differ with regard to their degree of supranationality and the way in which they derive their legitimacy. All this gives rise to a certain complexity, which often has its legitimate and understandable reasons (see Chapter 10), but which is not helpful from the point of view of easily understanding who does what in the policy process.

4.4 Voting rules and weights

The Council decides, as the case may be, by simple majority, qualified majority, unanimity or consensus (or common accord). Simple majority is mainly used for decisions on procedure. Most legal acts are adopted by either qualified majority or unanimity, while consensus applies mainly to political conclusions by the Council (when not closely related to an underlying legal act). It may be noted that unanimity allows for abstention (nobody opposed), while quality majority requires assent by all participants. Somewhat paradoxically, qualified majority may therefore require more positive votes than unanimity (as the latter condition might *in extremis* be fulfilled by one vote in favour and the others abstaining).

There has been a trend, particularly since the SEA, towards increased use of QMV in Council decision-making. This trend has been fed by the perception that deepening integration is inconceivable in conditions where the veto option constantly risks leading to deadlock. Also, the prospect of enlargment has strengthened the case for moving to QMV, because unanimity risks being very difficult to achieve in a union with an increasingly large and heterogeneous membership. In fact, QMV is used for most decisions of the Council. It is widely applied in the area of economic policy, notably in the area of the internal market, but also for decisions on economic policy coordination and most decisions on the Community budget. The requirement of unanimity remains for the financial perspective (see Chapter 9) and for issues that are politically particularly sensitive, such as taxation and much of social policy, and for quasi-constitutional decisions, such as changing the protocol on the EDP or conferring tasks to the ECB in the area of prudential supervision.

It is a noteworthy feature of Council decision-making that great efforts are made to broaden the majority even when the qualified majority has already been achieved. For instance, in the year 2003 the Council adopted 196 definitive legal acts, of which 136 had a legal base that would have allowed adoption by qualified majority. Yet, votes against in combination with abstentions were registered for only twenty-nine of these legal acts, in addition to which there were nine cases with only some abstentions (thus allowing unanimity). It may be added that voting is more common in the intermediary stages of legislation and notably for the Community budget (probably because the budget procedure involves numerous votes during the preparation of the budget).

Qualified majority is obtained when the amount of weighted votes in favour of a proposal exceeds a specified ceiling, which at the same time implies that those voting against or abstaining do not form a blocking minority. The total amount of votes for or against a proposal subject to vote are calculated by adding the weighted votes of individual member states. The weights of the various member states until 1 November 2004 and as of that date (the weights agreed in the Nice treaty) are as set out in columns 1 and 2 of Table 4.2, while columns 3 and 4 give the absolute and relative population figures. For a vote to be passed, according to the rules agreed in Nice, qualified majority must be obtained in combination with support of at least a simple majority of member states and at least 62 per cent of the population in the EU. (As pointed out by Galloway, 2001), it can rather safely be assumed that the latter two conditions are fulfilled if qualified majority is obtained.)

The definition of the weighted votes in the EU reflects a principle of 'degressive proportionality', according to which small member states

Table 4.2 Voting weights in the EU

	Weighted votes until 31/10/2004	*Weighted votes as of 1/11/2004*	*Population millions*	*Population %-share*
Germany	10	29	82.5	18.1
France	10	29	59.9	13.2
United Kingdom	10	29	59.5	13.1
Italy	10	29	57.5	12.6
Spain	8	27	41.0	9.0
Poland	8	27	38.2	8.4
Netherlands	5	13	16.3	3.6
Greece	5	12	11.0	2.4
Belgium	5	12	10.4	2.3
Czech Republic	5	12	10.2	2.2
Portugal	5	12	10.5	2.3
Hungary	5	12	10.1	2.2
Sweden	4	10	9.0	2.0
Austria	4	10	8.1	1.8
Denmark	3	7	5.4	1.2
Slovakia	3	7	5.4	1.2
Finland	3	7	5.2	1.1
Ireland	3	7	4.0	0.9
Lithuania	3	7	3.4	0.7
Latvia	3	4	2.3	0.5
Slovenia	3	4	2.0	0.4
Estonia	3	4	1.4	0.3
Cyprus	2	4	0.7	0.2
Luxembourg	2	4	0.5	0.1
Malta	2	3	0.4	0.1
Total EU25	124	321	454.9	100
Qualified majority	88 (71.0 %)	232 (72.3 %)		
Blocking minority	37	90		

are over-represented and large member states correspondingly under-represented in terms of voting strength (as compared to population shares). The aim of the principle is to strike a balance between the principle of 'one state, one vote', which would hold in a union of states, and the principle of 'one citizen, one vote', which would hold in a union of peoples. The weighted votes are thus a very concrete reflection of the dual nature of the EU. Not surprisingly, the definition of the weights of member states is invariably one of the most contested issues[5] in any intergovernmental conference (IGC), partly because they may acquire symbolic significance (as recognised measures of the political weight of member states), partly because member states naturally attach great importance to their ability to form a blocking minority (with a view to defending their national interests). The latest IGC has suggested that the Nice weighted votes scheme should be scrapped and replaced by the requirement of a double majority: any proposal would need to be supported by at least 55 per cent of member states (in terms of numbers of member states) in combination with at least 65 per cent of the total population in the EU.

4.5 Instruments and procedures of economic policy coordination

The economic policy regime in the treaty amounts to a rules-based framework with a specific allocation of competences and assignment of tasks. This is complemented by the principle of coordination, according to which 'member states shall regard their economic policies as a matter of common concern and shall coordinate them within the Council'. Coordination aims at ensuring that appropriate policies are effectively implemented, and that national policies take account of their implications for the Community. Monitoring and surveillance of economic developments and policies, and the associated policy dialogue at the EU level, aim at giving national decision-makers feedback with a view to guiding them in their evaluation and planning of policies. This section briefly sets out the most important instruments and processes that form part of economic policy coordination in the EU.

One may, in this context, make a distinction between three cases. First, deviation of policies of member states from agreed rules may lead to warnings and even sanctions. This is the case for legally *binding rules*, which clearly belong to the 'hard core' of the policy regime or the domain of 'strong' coordination (as is the case for the obligation to avoid excessive budget deficits). Second, the specification of objectives and their surveillance may aim at *peer pressure* in the form of advice and non-binding recommendations (as is the case for the economic policy guidelines). This is what differentiates a normative process of policy coordination from the third case, which involves only exchange of information and dialogue with a view to *mutual learning*.

It may be noted that the institutional position of the Commission is rather weak in the area of economic policy coordination. It still has the sole right of initiative for legal acts, but Council decisions are based on Commission recommendations rather than proposals. The Council is thus free to modify the text against the will of the Commission by qualified majority and does not need unanimity (as is the case for legal acts based on Commission proposals). This needs to be seen in the light of the fact that general economic policy basically remains within national competence.

4.5.1 Fiscal policy rules

The background to the fiscal rules is two-fold. On the one hand, it has been widely felt that there is an inherent political bias towards excessive budget deficits (for reasons which were already discussed in section 1.1 above). There is broad agreement that persistently large budget deficits and a rapid build-up of public debt are harmful in raising risk premia, complicating the task of monetary policy, reducing the room for manoeuvre of future fiscal policies, weakening capital formation and tilting income distribution in favour of present as compared to future generations. On the other hand, EMU may aggravate the fiscal deficit bias (as is shown in Chapter 6): borrowing might be encouraged by the fact that even large national budget deficits would be unlikely to trigger sizeable increases in the (euro-area-wide) interest rates or affect the exchange rate. Such behaviour, if widespread, could have systemic consequences and would risk undermining the good functioning of EMU. There is, in other words, concern about 'free-riding' behaviour in EMU, as the financial repercussions of national budget deficits may indirectly become a shared burden of all member states.

While leaving competence for fiscal policy with national governments, the treaty therefore also imposes obligations and constraints on what fiscal authorities can and should do. In particular, it obliges governments to finance budget deficits at market terms, allows no 'bail-out' of defaulting governments by the Community or other member states, and imposes ceilings on the size of acceptable government financial deficits and debts. The Excessive Deficit Procedure (EDP) forbids, as a rule, general government deficits in excess of 3 per cent of GDP. The treaty-based EDP was complemented in 1997 by the Stability and Growth Pact (SGP), which requires member states to produce stability or convergence programmes (of euro-area member states and of other member states respectively), and to aim at budgetary positions of close to balance or surplus in the medium term.

The fiscal rules, if strictly applied, restrain national sovereignty in budgetary matters. They have the great attraction of simplicity in that the target of budget balance and the avoidance of excessive deficits can be well understood by decision-makers, financial markets and the general public. If duly followed, the rules should safeguard debt sustainability while leaving sufficient room for 'automatic stabilisers' to operate. Also, compliance with the rules can be monitored with readily available statistics. The restriction on national sovereignty need not be perceived as severe, as it does allow member states to opt for a big or a small public sector and high or low tax burdens. The rules only aim at ruling out persistently large budget deficits of a sort which would normally be contrary to the interests of both the Community and each of the member states.

The fiscal rules have always been controversial and recently they have become a main object of criticism. This debate on the economic policy framework of the Community will be reviewed in Chapter 6, which will also examine the consequences of the EDP and the SGP for macroeconomic stability and policies.

Box 4.2 The SGP and the EDP

The SGP consists of two Council regulations and a European Council resolution. It should be seen in conjunction with the treaty-based EDP. The fiscal rules operate along two main lines. First, the commitment of member states to aim at balance or surplus in government finances in the medium term should create a safety margin against the risk that the 3 per cent of GDP ceiling on budget deficits is violated. As part of the surveillance of budgetary policies, member states notify the Commission about their budget developments and submit annual updates of their stability and convergence programmes. The Council, assisted by the Commission, assesses the programmes and gives opinions on them, monitors their implementation, may give 'early warnings' to countries which seem not to be on track for their medium term target, and may issue recommendations to member states concerned to take corrective action if slippage from targets is detected.

Second, the EDP becomes operative if a country runs an excessive deficit or comes close to doing so. If so, the Council will give recommendations to the member state concerned with a view to redressing the situation and may, if the member state fails to take sufficient action, decide on sanctions. These may take the form of an obligation for the member state concerned to make non-interest-bearing deposits or even to pay fines of up to 0.5 per cent of GDP. Also, the EDP should induce member states to take corrective action rapidly to rectify a situation of excessive deficit. However, the provisions on sanctions apply only for member states participating in the euro area. Discussions on the implementation of the EDP and the SGP take place in the Eurogroup for member states participating in the euro area, though formal decisions are taken in the Ecofin Council. The EDP and the SGP complement each other in the sense that the latter is designed to help ensure that the former is applied strictly. However, the procedures are highly discretionary and they always require an overall assessment and a political decision by the Council on a case-by-case basis.

4.5.2 Economic policy guidelines

The most important 'overarching' instrument of economic policy coordination is set out in Article 99 of the treaty, which requires the Council to develop Broad Guidelines of the Economic Policies (BEPGs) of the member states and the Community. These contain assessments and recommendations both for the EU as a whole, for the euro area and for the individual member states. The treaty also foresees that the implementation of these guidelines be monitored and assessed, and allows the Council to make recommendations if the economic policies of member states deviate from the BEPGs or risk jeopardising the proper functioning of EMU.

The BEPGs are expected to influence policy planning and action in member states but are not binding; there are no sanctions for failure to abide by the guidelines or associated recommendations. Instead, the main significance of the BEPGs is that they give expression to the agreed common view of member states on the economic policy strategy that the Community and its member states should follow. Needless to say, the views of member states often differ depending on national traditions and experiences, specific events and the political composition of governments. Drafting of the BEPGs is mostly done by consensus (though formally only qualified majority is needed), and the text unavoidably tends to reflect the 'lowest common denominator', therefore often lacking in boldness and clarity. Nevertheless, there is normally rather wide agreement on the main lines of the policies to be pursued. This concerns both the assessment of the economic outlook and the macroeconomic policy mix as well as the long-term challenges and priorities for structural policies.

The emphasis in the BEPGs is on the medium-term strategy and on structural or microeconomic policies. These policies, which may cover a very broad area, aim at improving the market mechanism and at strengthening the supply side and the growth potential of the economy. Action may be called for in the form of Community legislation, but often the structural reforms relate to actions that are the competence of member states. Indeed, structural policies tend to be associated with country-specific institutions and traditions, and their cross-border linkages are less obvious than macroeconomic interdependence. The subsidiarity principle thus implies a presumption that such policies should be and remain a matter for national decision-making. On the other hand, there are also considerations pleading for coordination or action at the Community level, the most important being that structural policies may have a bearing on the functioning of the internal market.

Box 4.3 The BEPGs and the coordination process

The process of producing the BEPGs starts with national reporting by member states (using the annual updates of stability and convergence programmes as well as special reports on structural issues). A 'Key Issues Paper' (KIP) on the BEPGs is presented by the Ecofin Council and is the subject of debate in the spring meeting of the European Council (see below). On the basis of further work (by the Commission and committees), the Council presents the BEPGs to the European Council in June and then adopts them. It has been agreed that the BEPGs should be subject to a full review with three-year intervals, the focus during the other years being mainly on implementation.

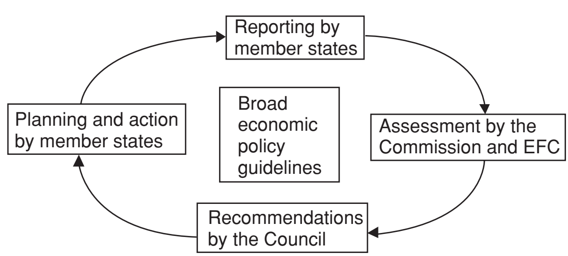

Figure 4.2 The BEPGs

The coordination process involves information sharing and peer pressure through multilateral surveillance of policies in the light of agreed guidelines, and it allows the EU level to play a helpful role in areas of national competence. The BEPGs have been the inspiration for many other coordination processes (see below).

4.5.3 The Lisbon process

The European Council, meeting in Lisbon in March 2000, agreed that it should devote an annual spring (March) meeting to discussions of economic and social issues. The March meeting is unique in that all the broad economic and social issues are on the table for consideration by the heads of state or government. The stated purpose of the Lisbon process was to relaunch a process of dynamism and structural reform, the strategic goal being that of making Europe 'the most competitive and dynamic knowledge-based economy in the world capable of sustainable economic growth with more and better jobs and greater social cohesion'.

The basic documentation for the spring meeting includes notably a synthesis report by the Commission and a Key Issues Paper on the BEPGs by the Ecofin Council. However, recent years have witnessed an escalation of policy coordination procedures, not only in the area of economic policies but also, *inter alia*, for employment and social policies. Some of these are treaty-based, such as the 'European Employment Strategy', which consists of employment guidelines, recommendations on employment policies to member states and surveillance in the form of examinations of annual national action plans for employment. Other processes have been set up on the basis of the conclusions of the European Council in Lisbon. In particular, it suggested an 'Open Method of Coordination' (OMC), to be applied in areas where no treaty-based instruments exist (such as pension systems, health expenditure or social inclusion). It takes the form of exchanges of information, benchmarking on the basis of structural indicators and the definition of best practices, and it aims at policy dialogue with a view to mutual learning as well as healthy competition and concerted action.

The goal of the Lisbon process (quoted above) is often deemed to reflect political rhetoric rather than realism. Yet the annual spring meeting of the European Council is important in that it allows the heads of state or government to get an overview of and assess progress achieved in the economic and social area, to reconcile differences between sectoral Council formations, to set priorities and to give impetus for further work through initiatives with specific remits and deadlines. The Lisbon process and the annual spring meeting have thus become the focal point for many of the Community's procedures in the economic and social area.

Annex: the preparatory machinery and decision procedures

The Union's procedures of preparation and decision are quite complex. The following will not attempt any detailed exposition but will mainly draw attention to the dichotomy between preparation of legislation as compared to coordination activities and refer to some of the important committees involved.

The preparation of decisions on Community *legislation*, on the basis of a proposal from the Commission, is made by working parties and committees in the Council (and committees in the European Parliament). Council Working Parties (WP) consist of experts from ministries in capitals and/or attachés from the permanent representations. The purpose of the work of these groups, such as the WP on financial services or the WP on tax questions, is to clarify the position of member states with a view to finding a basis for agreement.

The results of such deliberations are at some stage brought to the Committee of Permanent Representatives (COREPER), which then either takes over the dossier or sends it back to the working party with instructions for further work. Subsequently, the deliberations of COREPER are brought to the level of the Council with a view to political agreement and a formal decision, which may take place as an A point (no discussion) or a B point (deliberation).

A parallel process, including specialised committees, rapporteurs producing reports and amendments voted in plenary session, takes place in the parliament with a view to delivering an opinion or proposed legislative amendments to the Council. The interaction with the European Parliament is more complicated if the procedure foreseen in the treaty is *co-decision* (as is the case for financial services) rather than simple consultation (as is the case for taxation).

In the case of the co-decision procedure, first, the Council may accept the outcome of the European Parliament's first reading, in which case the act is adopted.

Box 4.4 Legal instruments in the EU

The legal instruments in use in the EU are as follows:

- A *Regulation* is an EU law that is directly binding
- A *Directive* is binding with respect to objectives and effects but requires national implementation through a process of transposition
- A *Framework directive* sets out binding objectives and approaches but needs to be followed up by specific directives
- A *Decision* is binding for the member state or the firm to which it is addressed
- A *Recommendation* is non-binding.

If not, the Council will adopt its common position, which is then considered by the Parliament in a second reading. Within three months the Parliament will then either approve the common position (in which case the act is adopted), reject the common position (in which case the act is not adopted), or propose amendments to the common position.

If so, then the dossier will be reconsidered by the Council in a second reading. Within a time limit of six weeks, the Council either accepts the amendments proposed by the European Parliament (and the act is adopted), or accepts only some of the amendments or rejects all of them.

If this is the case, then a Conciliation Committee will be convened, consisting of delegations from the European Parliament and the Council. Within a time limit of six weeks, the Committee will try to find a compromise acceptable to both insitutions, in which case the act can be adopted.[6]

Work on policy *coordination* is mostly prepared for the Council by special committees, which combine technical expertise with some political authority based on close relations to the relevant minister. The most important of these committees are the Economic and Financial Committee (EFC) and the Economic Policy Committee (EPC), both of which are bodies of high-level officials from ministries of finance or economy and central banks. The EFC is the more senior committee, and most of its members are close collaborators with their respective ministers. This allows the committee to play a key role in

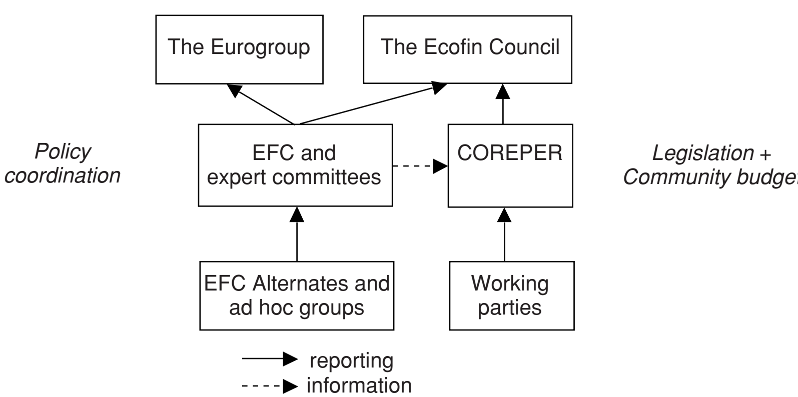

Figure 4.3 The Council's preparatory machinery

the preparation of Ecofin Council meetings. The EFC focuses on macroeconomic and financial issues, including international financial issues, and assumes the main responsibility for the preparation of both the BEPGs and the implementation of the EDP and the SGP as well as the work of the Eurogroup. The EPC deals more with structural and long-term issues and contributes notably to work on the BEPGs. Both committees have chairmen elected for a period of two years by the committee members (rather than following the rotating presidency), and secretariats located in the Commission (but acting under the instruction of the chairman of the committee). Work prepared by these committees normally goes directly to the Council without passing through the Committee of Permanent Representatives (COREPER), though the latter may be informed of the work.

Other high-level committees in the Ecofin area include the Financial Services Committee, which advises the Commission and the Council on policy matters in the area of financial services and markets, and the Code of Conduct Group on business taxation, a group which has been set up to coordinate action of member states against harmful tax competition. Finally, preparation of the Community budget involves work by the Budget Committee, consisting of budgetary experts from the permanent representations in Brussels, as well as conciliation meetings and 'trilogues ' (involving representatives of the three institutions).

There is no need to go into further details of the working methods of the Union in this context; they are set out in the Rules of Procedure of the respective institutions. The main observations are that the preparatory machinery has a dualistic structure, being different for legislation as compared to coordination. Also, a great number of preparatory bodies are involved in the process, depending on the subject matter. Finally, a number of these are high-level committees, reflecting the need to achieve a proper balance and interaction between technical expertise and political authority.

5
Macroeconomic Policy in the SOE

Economic policy covers a broad range of measures which differ, *inter alia*, with respect to their objectives, decision mechanisms, instruments, transmission channels and time frame. A key distinction is between macroeconomic and microeconomic policies. The latter affect particular sectors of the economy or are otherwise selective in their impact and are usually called structural policies. They are for good reasons also referred to as supply-side, long-term or sectoral policies. The role of the EU for structural policies will be reviewed in Chapter 7.

Macroeconomic policies have their main effect on the overall economic situation. They are for good reasons often referred to as demand, short-term, cyclical or stabilisation policies. The reference to demand is appropriate because these policies affect overall economic activity by influencing total demand for goods and services. The effect on demand may be direct, as when the government spends more on goods and services. More often the effect is indirect. For instance, the government may reduce taxes in order to leave more disposable income in the hands of households with a view to increasing private consumption, or the central bank may influence financial conditions with a view to affecting private investment. The reference to the cyclical situation and stabilisation is appropriate because macroeconomic policies are typically geared to keeping overall activity stable at a satisfactory level. The aim is to achieve a high rate of utilisation of existing productive resources and healthy economic growth without inflationary pressure. The focus of macroeconomic policy is on managing the economy in the short term (though subject to forecasting errors and political failures), while economic growth in the long term will mainly depend on the supply side (productive capacity) and on structural policies.

This chapter sets out a simple analysis of macroeconomic policy in a 'small open economy' (SOE). Building on the analysis, the next chapter will focus on macroeconomic interdependence in EMU and on the issues of economic policy coordination to which this interdependence gives rise. It will be practical to set out the analysis in formal terms, using some simple equations and graphs. In particular, the analysis recapitulates the so-called Mundell–Fleming (MF) model,[1] which is still the workhorse for much of the analysis of open economy macroeconomics (and is well established in basic macroeconomic text books).

5.1 The SOE-model

The key simplifying assumption invoked is that the economy or area under consideration is small relative to the world economy in the sense that the global rate of interest, world income and the foreign price level may be treated as given. A main point of the MF model is to clarify the importance of the exchange-rate regime for the effectiveness of macroeconomic policies, and a distinction is therefore made between the cases of fixed and flexible exchange rates. The model is set out by focusing on the conditions for the short-term equilibrium of the economy.

A first condition is that the level of domestic output must equal total demand for it. The SOE is producing a (homogeneous) domestic output which is absorbed domestically or exported abroad. Total demand is composed of domestic demand and net exports (the excess of exports over imports). Domestic demand consists of private demand and government expenditure. The condition may be formulated as:

$$Y = E[\underset{+}{(1 - t)Y},\underset{-}{R}] + G + T(\underset{-}{Y},\underset{+}{S/P}) + X \tag{5.1}$$

where Y is output or income (these being equal by definition), R the domestic rate of interest, G government expenditure and t the tax rate, X autonomous demand (other than government expenditure), P the domestic price level and S the exchange rate and the domestic price of foreign goods (the foreign price being normalised at unity). It is assumed in Equation (5.1) that demand of the private sector E (consumption and investment) is a positive function of net or disposable income and a negative function of the rate of interest (as indicated by the signs), while government expenditure is a policy parameter. Net exports T is taken to be a negative function of domestic income (which increases imports) and a positive function of competitiveness or the relative price of foreign as compared to domestic output. It is straightforward to see that equilibrium in the goods market implies a negative relation between the interest rate R and the income level Y: a higher interest rate implies less private spending (investment) and therefore less output for demand to equal supply. This negative relation between the interest rate and income is the so-called '*IS* curve' (well known to all students of macroeconomics).

The second equilibrium condition requires money supply to equal money demand. The standard assumption is that money supply M is under the control of the central bank, while money demand L is a positive function of income (because the demand for money depends positively on the volume of transactions) and a negative function of the interest rate (as holding interest-bearing bonds is taken to be the alternative to holding money):

$$M / P = L(\underset{+}{Y}, \underset{-}{R}) \tag{5.2}$$

It is easy to show that the money-market equilibrium condition implies a positive relation between the interest rate and the level of income: a higher interest rate reduces money demand, which implies that the level of income needs to be higher to keep money demand equal to the (given) money supply. This positive relation between the interest rate and income is the '*LM*-curve' (equally as familiar as the *IS*-curve).

The third equation is an arbitrage condition which must hold in conditions of perfect capital mobility; the expected return on domestic and foreign assets must be equal (interest parity). This requires the domestic interest rate to equal the sum of the foreign interest rate R_f and the expected rate of depreciation of the exchange rate π_S:

$$R = R_f + \pi_S \tag{5.3}$$

The MF model assumes static exchange-rate expectations (π_S=0), which is reasonable in the case of a credibly fixed exchange rate, and particularly for a country which is a member of a monetary union. The assumption is more doubtful for an economy with a flexible exchange rate. As shown in the Annex, however, the MF conclusions also hold under the assumption of rational exchange rate expectations.

The final condition characterises price behaviour or the supply side of the economy. It may be written as:

$$\dot{P} = \pi_P + v(Y - \bar{Y}) + u \tag{5.4}$$

where a dot indicates rate of change, π_P is expected inflation, $\bar{Y}$ potential output, u a stochastic supply shock with a mean of zero and v a positive constant. This relation, which states that inflation equals expected inflation but is also influenced by the level of output relative to its potential or 'natural' level, is the 'expectations-augmented Phillips curve', a relation of fundamental importance for modern macroeconomics.

The purpose of the analysis is to shed light on the potential role of macroeconomic policy. In terms of the instruments used, macroeconomic policy may be divided into fiscal and monetary policy. The former is under the control of the government and amounts to changes in taxes and government expenditure. The fiscal stance may be deemed expansionary if the government increases expenditure and/or reduces taxes, because such a shift should induce more public and/or private demand for goods and services (at a cost in terms of a weaker government budget). Fiscal policy is for analytical purposes often divided into two categories: a discretionary component, which reflects specific decisions by the authorities, and a part which reflects the automatic stabilisers or the effects of existing tax schemes (and transfer systems) in the light of changes in the economy. In particular, households and corporations pay less tax when the economy is in a recession (because of weak income developments), and the private sector correspondingly pays more tax in a boom. Such automatic changes in tax payments are reflected in the government budget and tend to stabilise disposable income and thereby private spending on goods and services.

Monetary policy is run by the central bank and amounts to changes in the money supply and thereby in the short-term interest rate. In reality, the transmission mechanism includes the whole spectrum of interest rates, from overnight rates in the interbank market to long-term bond rates, credit supply by banks, exchange rates and asset prices (equity and real estate), though the simple model compresses all these into 'the interest rate' and 'the exchange rate'. It is widely agreed that monetary policy has the capacity to influence overall demand and activity though the lags involved may be 'long and variable', making it difficult to use monetary policy for 'fine tuning' (precise management of cyclical developments). The monetary policy rule or strategy followed by the central bank will partly condition interest rate and exchange rate responses to shocks and is therefore important for the cyclical behaviour of the economy.

The scenario examined in this section is as follows: the SOE produces output *Y* at a price *P*. The level of potential output is given (a function of structural parameters), but authorities can use macroeconomic policy with a view to affecting aggregate demand and thereby the level of actual output. The main question to be examined is the following: is it possible for the authorities to use monetary and/or fiscal policy in order to offset disturbances (internal or external shocks) with a view to stabilising aggregate demand and thereby the level of output (and employment) in the short term?

Assume first that inflation expectations are static rather than rational and that inflation adjusts slowly (π_p constant and v small). The short-term level of output will then be geared to aggregate demand rather than to potential output, and the supply side as given by Equation (5.4) may effectively be ignored. This is the case assumed in the original MF model, and the standard textbook analysis of macroeconomic policies may then be set out graphically as in Figure 5.1.

The *IS* curve indicates the combinations of the interest rate and income level for which aggregate demand equals total output, while the *LM* curve is the locus of interest rates and income that equate money demand and supply. The short-term equilibrium of the economy is represented by the intersection of the two curves. However, the MF model also requires (for static exchange-rate expectations) that the domestic

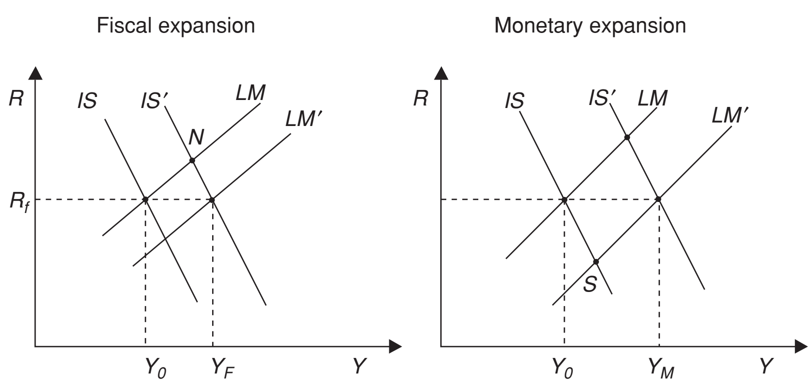

Figure 5.1 Macroeconomic policy in the MF model

interest rate is equal to the foreign interest rate, assumed to be given by world market conditions. The effects of macroeconomic policies under fixed and flexible exchange rates may then be set out as follows, where the left-hand panel examines fiscal policy and the right-hand panel monetary policy.

Assume that there is an exogenous increase in demand for domestic output, either as a consequence of an *expansionary fiscal policy* (an increase in government expenditure) or because of an increase in autonomous private demand. This will shift the *IS* curve to the right (to *IS′*), and the new intersection of the two curves (at point *N* in the left-hand panel of Figure 5.1) would imply a higher level of output and a higher interest rate. The significance of this depends crucially on the exchange-rate regime. Under *fixed exchange rates*, capital inflows would stabilise the interest rate at R_f. In fact, the central bank cannot control the money supply in the SOE under fixed exchange rates and perfect capital mobility, as the *LM* curve will shift until (at *LM′*) the domestic interest rate is again equal to the foreign rate (at income level Y_F). Fiscal policy is effective and its effectiveness is enhanced by the fact that it does not lead to any rise in the interest rate.

Under *flexible exchange rates*, by contrast, the (incipient) rise in the interest rate leads to a capital inflow and an appreciation of the exchange rate, which reverses the shift of the *IS* curve (as competitiveness and demand for domestic output is negatively affected). This process goes on until the *IS* curve has returned to its initial position, implying that the level of domestic output is unchanged (at Y_0). In fact, the only change as between the original situation and the new short-term equilibrium is that the exchange rate has appreciated and that net exports have fallen by the same magnitude as the increase in domestic demand. This recaps the standard MF result about the effectiveness of fiscal policy for the SOE: an increase in government expenditure will increase output at fixed exchange rates, without any negative repercussions on the interest rate, but will have no effect on output at flexible exchange rates, being fully offset by the negative demand effects of the appreciation of the exchange rate. One noteworthy implication of this analyisis is that membership in EMU should enhance the short-term effectiveness of fiscal policy as compared to staying outside the euro area (as it allows a credibly ‘fixed exchange rate’).

Assume next that the monetary authorities pursue an *expansionary monetary policy* by engineering an increase in money supply, thus shifting the *LM* curve to the right. The new intersection (at point *S* in the right-hand panel of Figure 5.1) would imply a higher level of income at a lower rate of interest. This situation will, under *fixed exchange rates*, be quickly reversed as capital outflows reduce money supply until the *LM*-curve has returned to its initial position, leaving both the interest rate and the output level unchanged.

Under *flexible exchange rates*, by contrast, the capital outflow induces a depreciation of the exchange rate. The resulting shift of the *IS*-curve will be such as to generate a new intersection at the world interest rate (with income at Y_M). These results recap the MF-conclusion about monetary policy: there is no autonomy of monetary policy in the SOE under fixed exchange rates, as the domestic interest rate (at perfect capital mobility) cannot deviate from the foreign rate, while monetary policy under flexible exchange is a powerful instrument for affecting aggregate demand through changes in the exchange rate and net exports. One noteworthy implication of this analysis is that membership in EMU may add to macroeconomic instability as it eliminates monetary policy from the set of policy instruments available at the national level.

It should be emphasised that the MF analysis is relevant only for the short term, or the time period during which changes in the expected and actual inflation rate are small enough to be ignored. The relevance of the analysis may therefore be rather limited. Monetary policy is an effective instrument for demand management, but this is of little use from the point of view of supporting economic activity if policy activism undermines price stability. To see this, note that Equation (5.4) may be rewritten as follows:

$$Y = \overline{Y} + (1 / v)(\dot{P} - \pi_P) - (1 / v)u \tag{5.4}$$

In this form the equation states that output will deviate from its potential level only if actual inflation exceeds expected inflation or because of stochastic (supply) shocks. Assuming that inflation expectations are 'rational' (equal to actual inflation) or are adjusting quickly towards actual inflation, Equation (5.4) implies the remarkable conclusion that demand management is unable to affect the level of output. Monetary and fiscal stimulus may possibly boost aggregate demand but will do so at the cost of higher inflation, and any output gain will be temporary and last only while inflation expectations adjust to the higher inflation rate.

In the light of this, consider what kind of macroeconomic policies one could expect the SOE to pursue. Analysis will focus on the case of flexible exchange rates, which may be considered the most relevant option for a member state of the EU not joining the euro area (the euro area is the focus of analysis in Chapter 6). Assume that the same decision-makers ('the government') have power over both fiscal and monetary policies, and that they set the policy instruments with a view to achieving macroeconomic stability. This is taken to mean that the level of output stays close to its target level, that the government's budget is close to balance and that inflation is close to zero. The government budget is expressed in cyclically adjusted terms, meaning that tax revenues are assessed at the level of potential output (rather than actual output). More specifically, assume that the authorities minimise the following loss function:

$$C = (1 / 2)[(Y - Y^*)^2 + \alpha(G - t\bar{Y})^2 + \gamma\dot{P}^2] \tag{5.5}$$

where Y^* is the target level of income (which may be higher than $\bar{Y}$), while α and γ are the relative weights of deviations from budget balance and from price stability. The assumption that the (structural) budget balance is of concern to decision-makers may be thought of as a proxy for intergenerational considerations, or it may reflect the need to safeguard room for manoeuvre for (future) stabilisation policies.[2] It is straightforward to show that optimal policies are characterised by the conditions:

$$G - t\bar{Y} = 0 \tag{5.6}$$

$$\dot{P} = (1 / \gamma v)(Y^* - Y) \tag{5.7}$$

The first condition states that the decision-maker will choose to keep government expenditure constant at the level of the cyclically adjusted tax revenues, a conclusion that is not surprising in view of the impotence of fiscal policy. There is no budget deficit bias and no fiscal policy activism, while 'automatic stabilisers' will be allowed to operate fully. The government will not react to changes in the budget balance caused by purely cyclical fluctuations of output and income (and therefore tax revenues). The second condition implies that the monetary policy pursued will have an inflation bias if $Y^* > \bar{Y}$, as may be the case if the government has excessive ambitions for growth and employment or is unduly optimistic with regard to the level of output consistent with price stability.

As already noted above, it should not be assumed that inflation expectations remain constant for long independently of economic developments and notably of actual inflation. Monetary stimulation may be used to enhance aggregate demand and this may lead to an expansionary bias in policy, but it will not raise the level of output once inflationary expectations have adjusted (as inspection of Equation (5.4) demonstrates). The noteworthy feature of the inflation bias is indeed that it will not be associated with any durable output gain; an expansionary monetary policy will on average only produce more inflation. Yet the policy yielding zero inflation, while socially optimal, will not be chosen by decision-makers pursuing discretionary policy with a short time horizon. As has been explained by Barro and Gordon and others,[3] a policy of zero inflation will not happen because it is 'time-inconsistent'.

The standard solution to this dilemma is to suggest that monetary policy be delegated to an independent and conservative central bank mandated to safeguard price stability. Assuming that the output target in the loss function of such a central bank is $\bar{Y}$, the inflation bias would disappear, inflation now being given by:

$$\dot{P} = u \, / \, \gamma v^2 \tag{5.8}$$

which has an expected value of zero. The central bank might even go further in its endeavour to ensure price stability; it could ignore output deviations and react only to price developments, in which case it would achieve a zero variance of inflation. However, it may be shown that such a policy would be at the expense of the stability of income (even if its expected level were unaffected[4]). Thus, there is a trade-off after all: a monetary policy geared strongly and only to inflation may indeed stabilise the price level but will do so at the cost of higher output variability.

This analysis recaps the basic lesson that the role of macroeconomic policy depends crucially on the supply side and the price mechanism. With pervasive (wage and) price rigidities, output will tend to be determined by aggregate demand in the short term. This gives scope for macroeconomic policy to help stabilise aggregate demand and output. Fiscal policy will be effective under fixed exchange rates (notably in EMU), while monetary policy will be effective under flexible exchange rates. Both conclusions are of particular importance in case countries are hit by idiosyncratic or 'asymmetric' (country-specific) shocks, which either require adjustment through relative price changes or need to be offset by policy actions.

With flexible prices and rational inflation expectations, by contrast, the scope for macroeconomic policy is much more restricted: there is no case for fiscal activism and institutions should be designed to ensure that the central bank is committed to price stability (though allowing some short-term deviations). This classical (or 'new classical') view, which has strongly influenced economic policy thinking since the early 1980s, dismisses active demand management as useless and emphasises the importance of supply-side policies (raising potential output). Macroeconomic policy should not be used to steer the economy in the short run. Monetary and fiscal policies should rather aim at enhancing an effective functioning of the economy in the long run and may best serve this aim by being oriented towards price stability and balanced budgets respectively.

An important additional observation in this context is that governments can finance their expenditures mainly in three ways: by taxing their citizens, by borrowing on financial markets, or by printing money and thereby increasing its supply (assuming that the government has power over the central bank). Taxation is extensively used but high tax rates distort economic incentives and are widely resented by citizens. Government borrowing is a popular option but only shift the burden over time, and is destabilising by adding to interest payments and thereby budget deficits. Increasing money supply by running the printing press is a recipe for inflation. It may seem attractive to politicians though, as it avoids the need to raise taxes or increase borrowing, and as the rise in inflation reduces the real value of the outstanding stock of government debt. Practical experience abundantly illustrates the tendency of governments, particularly governments faced with strained public finances, to insist on monetary stimulus to ease the financing of deficits as well as to support economic growth. Again, however, the favourable effects (if any) may last only as long as inflation is unanticipated. Once expectations catch up, nominal interest rates will rise to match the higher rate of inflation and, most likely, to compensate for a perceived rise in inflation risks. It is therefore wise to resist the temptation to seek short-term gain while compromising credibility and long-term sustainability.

This reasoning is the basis for the trend, which has been pervasive in recent decades, to safeguard the independence of central banks. The same perspective is fundamental to EMU, which may in this perspective be seen as an institutional device for creating a credible framework for monetary policy geared to price stability. In particular, the strong independence of the ECB should lend credibility to its treaty-based commitment to price stability, thus helping to avoid the temptation of pursuing a politically motivated policy of monetary expansion in the short term at the cost of undermining price stability in the long term. The effectiveness and credibility of policies are therefore important not only for the macroeconomic management of the SOE in general, but also for the relative attractiveness of alternative exchange rate regimes and notably of the option of joining EMU as compared to staying outside (Box 5.1).

Box 5.1 The OCA literature

Joining a currency area with fixed exchange rates or with a single currency means giving up monetary policy as an instrument at the disposal of national authorities. On the other hand, the single currency reduces transaction costs and exchange rate uncertainty, and should thereby enhance the efficiency of the market mechanism. Thus, a decision to join EMU is associated with macroeconomic costs and microeconomic benefits.

There is an extensive literature discussing the determinants of the 'Optimum Currency Area' (OCA), the criteria that could guide countries in their choice of the exchange rate regime. Mundell (1961) emphasises the role of wage flexibility for fixed exchange rates to be credible, particularly in conditions of low cross-border mobility of labour. He also underlines the need for structural convergence with a view to reducing the risk of asymmetric shocks which may cause adjustment problems. Kenen (1969) stresses that countries with a well diversified production structure should be less at risk of asymmetric shocks undermining the viability of a currency area than countries that are highly specialised. Krugman (1991) suspects that integration itself may intensify regional concentration of production, but the empirical evidence presented by Frankel and Rose (1996) suggests that monetary integration reduces the risk of asymmetric shocks. McKinnon (1963) argues that highly open countries should benefit from participating in a currency union because devaluations are then quickly translated into higher domestic prices, and a high import ratio reduces the cost of using domestic demand management to improve the external balance. In fact, several of the considerations referred to above may be related to the degree of openness of the economy, and Krugman has suggested that the costs and benefits of membership in EMU may as a first approximation be depicted as in Figure 5.2.

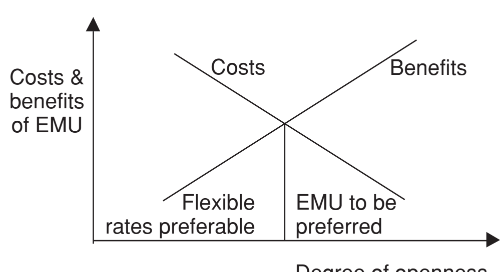

Figure 5.2 EMU and openness

Thus membership of a currency union is to be preferred if the economy is sufficiently open. Also, EMU is viable or desirable only if its institutional set-up is such as to allow or enhance both macroeconomic stability and credibility of low inflation, an aspect dealt with notably by De Grauwe (1997). Much of the analysis in Chapter 6 is therefore relevant for the OCA issue even though the choice of the exchange-rate regime as such is not at the forefront of the analysis.

5.2 The SOE-model revisited

While the MF-model is attractively simple, some of its conclusions do not seem very robust. This section will review and modify some of the key assumptions of the SOE model under flexible exchange rates. To recap, its most remarkable feature is that fiscal expansion has no effect on aggregate demand because it is offset by an immediate appreciation of the exchange rate. This extreme 'crowding out' view of fiscal policy is a rather peculiar one: it happens that the exchange rate changes abruptly, and it is only appropriate that this essential feature of the flexible exchange-rate system be incorporated in the analysis. However, it is not always the case that fiscal expansion leads to an appreciation of the exchange rate; in fact, it is widely thought that an increase in the budget deficit (actual and/or expected) may rather weaken the exchange rate. Even more questionable is the assumption that the shift of resources from net exports to production for domestic demand takes place instantaneously. Clearly the shift of resources is likely to take quite some time. It is unsatisfactory to assume that the process is completed within the time span relevant for analysis of short-term or cyclical developments.

There is an inherent difficulty in capturing the process satisfactorily (in a model with full specialisation in production), but there are nevertheless ways in which one may introduce a gradual adjustment process into the reaction of output to changes in the exchange rate. A particularly simple approach[5] is to assume that the exchange rate, which is perceived by firms and households as 'permanent' in their pricing and spending decisions, may differ from the actual exchange rate while adjusting gradually to it:

$$\dot{C} = z(S - C) \tag{5.9}$$

where C is the 'permanent' exchange rate and z the speed of adjustment. It is obvious that this assumption will help to restore some short-term effectiveness to fiscal policy; crowding out through the exchange rate will not happen instantaneously but only over time.

While full crowding out by net exports is unlikely to nullify the effects of fiscal policy (in the short term), there are other reasons for doubting its efficiency. First, the private sector may adjust its rate of saving in response to the government's budget deficit so as to leave demand unaffected (Ricardian equivalence [6]), a possibility which is not pursued in this context. Second, any changes in aggregate demand may lead to price changes rather than to an increase in real output (as seen above). Third, an increase in the budget deficit may, notably if the public debt level is high, have negative repercussions on confidence by increasing uncertainty about future inflation (in view of the risk of a 'monetary bailing out') or by causing concern about the possibility of government default on its debt. A simple way of capturing these effects is to introduce a default risk premium into the interest parity condition:

(5.10) $$R = R_f + \pi_S + \rho$$

where $\rho = \rho(G - t\bar{Y})$ with $\rho' > 0$, indicating that an increase in the structural budget deficit will lead (in some situations) to a risk premium, thereby giving rise to an additional wedge between the domestic and the foreign rate of interest. A further aspect which merits attention concerns exchange rate expectations, which in the MF model are taken to be static. An alternative assumption often used and adopted in this section is that of rational expectations or (as the model is non-stochastic) of perfect foresight:

(5.11) $$\pi_s = \dot{S}$$

Finally, the consequences of fiscal policy will depend significantly on the reactions of monetary authorities. In particular, it may be that the central bank will adjust the interest rate with a view to maintaining price stability but also wants to avoid sharp swings in the exchange rate relative to the value which is perceived as 'normal'. Assume therefore a monetary policy or an interest rate response function like:

(5.12) $$R = k_P \dot{P} + k_S (S - C) + k_M [PL(Y,R) - M]$$

where k_P indicates the policy reaction to a deviation of inflation from its target rate of zero, and where k_S reflects concern about the exchange rate, while k_M indicates adjustment of the interest rate in response to a deviation of the nominal money stock (as determined by the demand for money) from its target value *M*. To focus analysis on these elements, it is for the time being assumed that the price level may be treated as given. The revised SOE model is composed of Equations (5.9)–(5.12) in combination with:

$$Y = E[(1 - t)Y,R] + G + T(C/P) + X, \tag{5.13}$$

which differs from Equation (5.1) only for the relative price term (this now being *C/P* rather than *S/P*).

One distinguishing characteristic of this model (or type of model) is that exchange rates (asset prices) adjust instantaneously while other variables adjust only gradually over time. The exchange rate immediately 'jumps' in response to shocks or policies and may 'overshoot' its equilibrium value during the adjustment period. As shown in the Annex, the adjustment process may be analysed as in Figure 5.3, where the *SS*-curve indicates the locus of *S* and *C* for which $\dot{S} = 0$, while the *CC*-curve is the corresponding locus of *S* and *C* for which $\dot{C} = 0$. (The slope of the *SS* curve may, depending on the size and sign of the various parameters, be positive rather than negative.) The arrows indicate the direction of movement of *S* and *C* when not on the equilibrium curve.

Assume that the initial value of *C* is C_0 in the figure in the left-hand panel. Given the dynamics of the model, the only trajectory leading to equilibrium at point *E*, at the intersection of the *SS* and *CC* curves, is the one indicated by *TT*. It is assumed that the exchange rate always adjusts immediately so as to be on this stable trajectory. It will therefore momentarily be at S_0, and will thereafter appreciate gradually as *C* adjusts towards its equilibrium value at *E*.

Assume next that the government undertakes fiscal expansion (increasing government expenditure). This will shift the *SS* curve downwards to *SS′* (Figure 5.3, right-hand panel). The new short-term equilibrium is at the point on the new trajectory *TT′* corresponding to C_0 (at point *U*), and the short term equilibrium will then shift gradually along *TT′* until reaching the new (full) equilibrium at *E′*. This implies that fiscal expansion will first cause an immediate and discrete appreciation of the exchange rate, followed by a partial reversal through a process of gradual depreciation over time.

The initial appreciation of the exchange rate has no immediate direct consequences for demand or output (because of the lag in the effect of competitiveness and the gradual adjustment of net exports). However, the domestic interest rate will rise above the foreign rate so as to compensate for the gradual depreciation of the exchange rate (taking place along the *TT'* trajectory) and possibly because of a rise in the risk premium.

As shown in the Annex, fiscal expansion will definitely raise output in the short term if $k_S = 0$ in the interest rate reaction function. The interest rate will rise somewhat but not enough to mitigate the positive demand effect of an increase in government expenditure. Over time, however, the deterioration in competitiveness will affect net exports and output negatively, and the proposition that fiscal expansion leaves output unaffected may (but need not) hold once the adjustment process has been completed.

The short term effects of fiscal expansion are less clear-cut if $k_S > 0$. This reintroduces a link from the exchange rate to output through the interest rate reaction to exchange rate changes (even if the negative competitiveness effect is not immediately operative). As a consequence, fiscal expansion may influence the interest rate by affecting confidence ($\rho' > 0$) as well as through its effect on the equilibrium exchange rate, and the effects on both the exchange rate and output become ambiguous. In particular, fiscal expansion may lead to a depreciation of the exchange rate. This corresponds to the ample 'anecdotal evidence' suggesting that fiscal expansion and budget deficits weaken the exchange rate (while fiscal expansion in the standard MF model

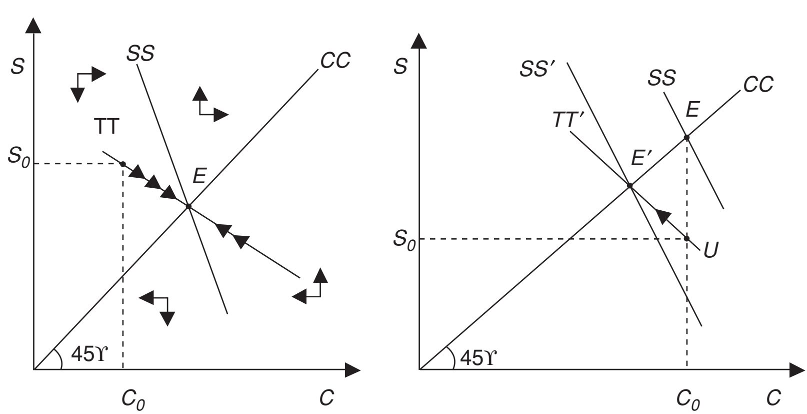

Figure 5.3 Exchange rate overshooting

always strengthens the exchange rate). Also, fiscal expansion may in the short term lead to a decline in overall demand and output if the confidence effect is strong enough; fiscal expansion thus risks being ineffective and even counterproductive.

In all, these modifications of the SOE model provide for a richer menu of possible effects of fiscal policy actions. Above all, fiscal policy is not necessarily impotent: an increase in domestic demand does not immediately lead to an equivalent crowding out of net exports. It may stimulate output though the interest rate will rise while the exchange rate may appreciate or depreciate depending on confidence effects. However, it may also be the case that fiscal expansion is ineffective with regard to output and it may even lead to a decline in activity if negative effects on confidence and risk premia are strong enough.

This richer menu of possible outcomes should, needless to say, affect policy behaviour in the SOE. For instance, a cut in public expenditure may be the right way to get out of a slump if the reward in terms of improved confidence and lower interest rates is big enough. However, the optimal policy of the SOE will not be explored here. The analysis of this chapter will instead be adapted to the case of a monetary union with a view to examining cross-border effects and the case for economic policy coordination.

Annex: fiscal policy in the SOE

Section 5.1

To recap, the original MF model essentially consists of the equilibrium conditions for the goods and money market:

$$Y = E[(1 - \underset{+}{t})\underset{-}{Y},R] + G + T(\underset{-}{Y},\underset{+}{S/P}) + X \tag{5.1}$$

$$M / P = L(\underset{+}{Y},\underset{-}{R}) \tag{5.2}$$

Assuming static exchange-rate expectations implies that the domestic interest rate equals the foreign rate (for interest parity to hold): at fixed exchange rates, output is determined by Equation (5.1), which now takes the form of the simple Keynesian 'multiplier model', while Equation (5.2) can only determine the money stock (which becomes endogenous). At flexible exchange rates, by contrast, output is determined by Equation (5.2), which becomes a monetary model of income determination, while the role of Equation (5.1) is to determine the exchange rate.

The MF model assumes static exchange-rate expectations but the results remain valid for the case of rational expectations. To see this, note that aggregate demand, using Equations (5.1) and (5.2), may be written:

$$(5.A1) \qquad Y = f(\underset{+}{G}, \underset{+}{S}, \underset{-}{P}, \underset{+}{M}, \underset{+}{X})$$

that is, it depends positively on autonomous demand (G and X) as well as the money stock and the exchange rate and negatively on the price level. Using Equations (5.2), (5.4), (5.11) and (5.A1), the dynamic model for the SOE can now be stated more compactly (in terms of deviations from equilibrium) as:

$$(5.A2) \qquad \begin{bmatrix} \dot{S} \\ \dot{P} \end{bmatrix} = \begin{bmatrix} -L_Y f_S / L_R & -(L_Y f_P + M)/L_R \\ v f_S & v f_P \end{bmatrix} \begin{bmatrix} S - \tilde{S} \\ P - \tilde{P} \end{bmatrix}$$

where $f_S = \partial Y/\partial S > 0$ and $f_P = \partial Y/\partial P < 0$ are as given by Equation (5.5). The value of the coefficient matrix is negative ($\Delta = vMf_S/L_R < 0$), which means that the model is dynamically unstable.

For equilibrium to be achieved, therefore, the exchange rate will have to 'jump' instantaneously to its new equilibrium in response to shocks.[7] Assuming this to be the case, Equation (5.3) implies that the domestic and foreign rate of interest will always be equal. Leaving aside, for the time being, the supply side in the form of Equation (5.4), the level of income is then determined by the real money stock, according to Equation (5.2), independently of autonomous demand:

$$(5.A3) \qquad Y = \phi\,(\underset{+}{\mathrm{M/P}})$$

while the exchange rate is determined residually by Equation (5.1). This restates the standard MF conclusion about the impotence of fiscal policy for a SOE at flexible exchange rates: an increase in government expenditure will have no effect on output, being fully offset by the demand effects of the change in the exchange rate (which appreciates by $\partial S/\partial G = -1/e$). Monetary policy, by contrast, is a powerful instrument for affecting aggregate demand through variations in the money supply, which induce changes in the exchange rate and net exports.

Section 5.2

The revised SOE-model consists of Equations (5.9)–(5.13). Using the notation (where subscripts denote partial derivatives) $s=1-E_Y(1-t)$, $m = -T_Y$ and $e = T_{S/P}$, the resulting dynamic model may now be stated more compactly as:

$$\text{(5.A4)} \qquad \begin{bmatrix} \dot{S} \\ \dot{C} \end{bmatrix} = \begin{bmatrix} \mu & \sigma \\ z & -z \end{bmatrix} \begin{bmatrix} S-\tilde{S} \\ C-\tilde{C} \end{bmatrix}$$

where $\mu = (s+m)k_s/\Delta$, $\sigma = [ek_M L_Y-(s+m)k_s]/\Delta$, $\Delta = (s+m)(1-k_M L_R)-E_R L_Y k_M$ and $\tilde{S} = \tilde{E} = -(1/e)(G+X)+[s+m)(1-k_M L_R)-E_R L_Y k_M](R_f+\rho)+[(s+m)/eL_y]M$.

This system is unstable, having the characteristic values:

$$\lambda_1 = \frac{1}{2}\left[\mu - z - \sqrt{(\mu - z)^2 + 4(\mu + \sigma)}\right] < 0$$
$$\lambda_2 = \frac{1}{2}\left[\mu - z + \sqrt{(\mu - z)^2 + 4(\mu + \sigma)}\right] > 0$$

of which λ_1 is the stable (negative) one. Determining initial conditions so as to retain only the stable root λ_1, allows the exchange rate to be expressed as:

$$\text{(5.A5)} \qquad S(t) = [\sigma / (\lambda_1 - \mu)](C - \tilde{S})e^{\lambda_1 t} + \tilde{S}$$

which (at $S(0)$) implies:

$$\partial S/\partial G = [(\mu + \sigma - \lambda_1)/(\mu - \lambda_1)]\{-(1/e) + [(s+m)(1-k_M L_R) - E_R L_Y k_M]\rho'\}.$$

Finally, Equations (5.12), (5.13) and (5.A6) give:

$$\partial Y/\partial G = (1/\Delta)[1 - k_M L_R + E_R k_S(\partial S/\partial G)]$$

which is the basis for the comments at the end of section 5.2 above. The slopes of the *SS* and *CC* curves used in Figure 5.3 may be derived by setting (5.A4) = 0.

6
Macroeconomic Policy in the EMU

Macroconomic policy and policy coordination in EMU remain controversial issues. This is not surprising in light of the fundamental policy asymmetry built into EMU: power over monetary policy is delegated to the ECB, thereby centralised in the hands of a highly independent supranational institution. Other economic policies, by contrast, remain a matter for national governments, though subject to the rules of the internal market and the SGP. As noted above, the euro is a 'currency without a state' and as such lacks historical precedent. This adds to the pertinence of the basic questions: is this asymmetric policy configuration problematic, perhaps even unsustainable, or is it a matter of little concern, perhaps even desirable? What is the appropriate relation between economic policy decisions of member states and of the euro area as a whole? How should we define the aims and boundaries of policy autonomy, policy discipline and policy coordination?

One view of EMU is that it will function well (only) if markets are flexible, if domestic prices and wages adjust as required by country-specific shocks, and if disciplined budgetary policies maintain sound public finances while leaving ample room for automatic stabilisers to operate. The government of each member state should concentrate on 'putting its house in order'. Policy coordination, if any, should amount to establishing a set of common rules and monitoring that they are respected, otherwise leaving member states free to pursue their policies independently.

A different view is that EMU, as set out in the treaty and as we know it today, needs to be complemented by a political edifice in the form of a 'Euro council' or an 'economic government' with important decision-making powers, capable of discretionary coordination of economic policies. EMU should also be associated with more power at the

Community level over, *inter alia*, taxes and social policies. Crudely (but only somewhat misleadingly), the contrast is between a 'technocratic' EMU with a liberal flavour and a 'political' (more activist or interventionist) EMU. The issues involved are of great significance for economic policies and also for how the institutional framework of Community decision-making should be designed. The differences of view are not easily resolved; they are not a matter of analysis only but also of vision or *Weltanschauung*.

Building on the analysis introduced above, this chapter makes a number of points on cross-border policy effects in a monetary union and on the case for macroeconomic policy coordination. In particular, it examines the cross-border effects of shocks and policies under different assumptions about the monetary policy strategy (section 1), the case for fiscal policy coordination (section 2), the role of relative price changes in the adjustment process (section 3), the potential usefulness of a 'stabilisation fund' at Community level for helping member states hit by asymmetric shocks (section 4), and the role of the SGP in ensuring stable public debt dynamics (section 5). Finally, the chapter makes an appraisal of the 'EMU policy assignment', which de-emphasises discretionary policy coordination and gives priority to a clear assignment of roles and responsibilities between the different policy authorities (section 6). A formal analysis of some of the points is to be found in the Annex.

6.1 Cross-border effects in a monetary union

The key feature of the institutional design of EMU, from the point of view of economic policy, is that a single currency (the euro), a single central bank (the ECB) and a single monetary policy coexist with multiple national governments that are, by and large, free to decide on their budgets and fiscal policies. The question addressed in this chapter is how this asymmetry between centralisation of monetary policy and decentralisation of fiscal policy affects overall policies.

The framework used is essentially the simple model of Chapter 5 applied for the case of a two-country monetary union (the model is set out in the Annex to this chapter). A key assumption to be retained is that Monetary Union itself is small in global terms; that is, world income and the level of the global interest rate as well as foreign prices are treated as given. This allows the focus to be on the interaction between the member states of the Monetary Union. It is first assumed that both countries are characterised by the MF relations set out in section 5.1, with the addition that money supply is decided by the monetary authorities of the Union (the ECB) and that it must equal the sum of money demand in the member states. Consideration is subsequently given to a revised model incorporating the modifications discussed in section 5.2.

Assume that the home country pursues an expansionary fiscal policy. How will this affect economic activity in the home country, the neighbour country and the Union as a whole? Given the assumptions made (including the assumption that the Union is small relative to the rest of the world), the conclusions are very simple. In particular, the MF conclusion on the impotence of fiscal policy will hold: fiscal expansion has no effect on the level of activity in the Union as a whole because the direct demand effects are in the aggregate, offset by the indirect effects of the appreciation of the exchange rate and its negative consequences on area-wide net exports. While fiscal expansion is ineffective with regard to overall economic activity in the Union, it increases domestic demand at home to an extent which more than counteracts the negative effects on net exports of the appreciation of the exchange rate, while the reverse holds for the neighbour country. The reduced forms for output may thus be written as:

$$(6.1) \qquad Y_i = \phi_i(\underset{+}{G_i}, \underset{-}{G_j}, \underset{+}{M}), \quad \partial Y_i / \partial G_i = \phi_{ii} = -\phi_{ji} = -\partial Y_j / \partial G_i > 0$$

which means that fiscal expansion is effective from the point of view of the country pursuing it but constitutes a 'beggar-thy-neighbour' policy: the positive effect on aggregate demand occurs at the expense of a contractionary effect in the rest of the Union.[1] For monetary policy, it remains the case that money supply will positively affect the level of demand in both countries and the Union as a whole.

The model just set out is simple and the conclusions correspondingly straightforward. Matters become somewhat more complicated when assuming, along the lines of section 5.2, that the 'permanent' exchange rate adjusts gradually in response to fluctuations in the actual exchange rate, that the (structural) budget deficit may affect the differential between the foreign and domestic interest rate in the form of a risk premium, and that interest rates are set according to a policy reaction function of the central bank. As seen in the Annex, such a model becomes too complicated to yield unambiguous conclusions.

The variety of conceivable cases can best be illustrated by looking at the short-term effects of fiscal policy and exogenous shocks on output for three different cases of the monetary policy reaction function defined by Equation (5.12) (see Table 6.1). The three cases covered are: (1) a *stable currency* ($k_S \to \infty$): the interest rate is set so as to keep the exchange rate unchanged; (2) a *stable money stock* ($k_M \to \infty$): the interest rate is adjusted so as to keep money demand equal to the given target stock of money; and (3) a *stable price level* ($k_P \to \infty$): the interest rate is adjusted so as to prevent inflation from deviating from its target value of zero. The signs of the output effects of fiscal policy as well as of an exogenous increase in (other) autonomous demand and of a supply shock can be summarised as follows (the first column in each block indicating the domestic effect of a domestic policy or shock, the second column the effect on the neighbour country, and the third column the effect on the Union as a whole).

The intuitive explanation of these signs is as follows: a *stable currency* amounts to a very 'accommodating' monetary regime, in which the central bank sets the interest rate as required by the interest parity condition while keeping the exchange rate unchanged. Actual output responds positively to demand and is (in the short term) independent of the supply side. Fiscal expansion may make it necessary to raise the interest rate to keep the exchange rate constant if there is a negative confidence effect, and this is the reason for the caveat (indicated by brackets) with regard to the positive fiscal policy effects. In particular, the confidence effect may imply that the cross-border effect of fiscal policy is negative, because the rise in the interest rate is the same for both countries[2] while the demand effect of fiscal expansion predominantly benefits the country undertaking the measures.

A *stable money stock* implies that an increase in activity will definitively be accompanied by a rise in the interest rate. The domestic

Table 6.1 Comparative statics in EMU

	Fiscal policy			*Demand shock*			*Supply shock*		
	$\frac{\partial Y_i}{\partial G_i}$	$\frac{\partial Y_j}{\partial G_i}$	$\frac{\partial Y}{\partial G_i}$	$\frac{\partial Y_i}{\partial X_i}$	$\frac{\partial Y_j}{\partial X_i}$	$\frac{\partial Y}{\partial X_i}$	$\frac{\partial Y_i}{\partial_i}$	$\frac{\partial Y_i}{\partial_i}$	$\frac{\partial Y}{\partial_i}$
(1) stable currency ($k_S \to \infty$)	(+)	(+)	(+)	+	+	+	0	0	0
(2) stable money stock ($k_M \to \infty$)	+	?	+	+	?	+	0	0	0
(3) stable price level ($k_P \to \infty$)	+	–	(0)	+	–	(0)	–	–	-

effect of fiscal expansion will be positive, while the rise in the interest rate makes it possible or likely that the spillover on the neighbouring country is negative. The currency is likely to appreciate, but this crowds out net exports only gradually over time without immediate negative output effects.

Box 6.1 Ready reckoners

Effects of fiscal and monetary policies may be illustrated by simulating econometric models describing economic relations within and between the EU member states and other world regions. The OECD recently presented such calculations made by simulating its INTERLINK model, and some of the results are reproduced in Table 6.2 below.

The first three rows indicate the effects on the euro area of an increase in government consumption by 2 per cent of GDP in France and Germany (as compared to the baseline) at unchanged interest and exchange rates. This amounts to an expansionary fiscal impulse of 1 per cent of GDP for the euro area as a whole (France and Germany together amounting to roughly half of the euro area economy as a whole). As is seen, fiscal expansion raises output, the multiplier for the euro area as a whole being marginally bigger than 1, while inflation increases somewhat and the budget balance deteriorates. It may reasonably be assumed that the output effects are sizable mainly for France and Germany, because of the direct demand effects, but are small for the other member states, which only benefit from effects via trade.

Table 6.2 Effects of fiscal and monetary policies in the euro area

	euro area	*year 1*	*year 2*
1. Increase in public consumption	output	1.2	1.0
in France and Germany by 2%	inflation	0.2	0.6
of GDP (1% of euro area GDP)	gov. lending	–0.6	–0.8
2. Higher interest rates	output	–0.4	–0.6
(by 100 basis points)	inflation	–0.1	–0.1
in the euro area	gov. lending	–0.4	–0.6
3. Appreciation of the euro by 10%	output	–0.8	–0.9
(in nominal effective terms)	inflation	–0.7	–0.7
	gov. lending	0.1	0.0
4. Fiscal expansion (as above)	output	0.6	0.2
+ 50 basis point higher interest rates	inflation	–0.2	0.2
+ 5% appreciation of the euro	gov. lending	–0.7	–1.1

Source: OECD (2003a).
Figures for output refer to deviations from baseline in per cent, while inflation effects are deviations in percentage points, and government lending deviations from baseline ratio to GDP in percentage points.

The second set of rows show the area-wide effects of a tightening of monetary policy such as to raise short term interest rates by 100 basis points. This reduces output by 1/2 per cent, and inflation somewhat, and increases budget deficits. The third section indicates the effects of a 10 per cent appreciation of the euro, which, according to the model, reduces euro area output by almost 1 per cent of GDP, reduces inflation by more than 1/2 per cent and leaves budget deficits roughly unchanged.

In practice, fiscal policy is also likely to trigger some changes in interest rates and exchange rates. These effects depend on factors such as the monetary policy reaction function and confidence effects. Thus, the total effects of fiscal policies may vary greatly, depending on circumstances. For instance, assume that the fiscal expansion above is associated with an interest rate increase of 50 basis points and an appreciation of the euro by 5 per cent. This would mean that output increases much less (by 0.6 and 0.2 per cent for years 1 and 2 respectively), while inflation on average is unaffected, and the general government financial position would be worse by 1 per cent of GDP in the second year for the euro area as a whole (and much more so for France and Germany).

This example illustrates the risk of fiscal expansion resulting in a bad policy mix, with crowding out of demand and output via interest rate and exchange rate effects, rather than in more growth. Note that this example would obviously be associated with negative output effects for other member states (than France and Germany), as the negative effects through the monetary channels would dominate any (small) positive trade effects.

A *stable price level* amounts to a vigorously non-accommodating monetary policy. Fiscal expansion by the home country will increase its level of activity, but will do so at the expense of activity in the neighbour country because of the rise in the interest rate needed to keep overall demand at potential output and the price level stable. Overall output will increase only if the sensitivity of inflation to the output gap is smaller in the home country than in the neighbour country, in which case the reallocation of demand will reduce overall inflation pressure in the union. Any increase in supply (potential output) will increase activity overall (by reducing inflationary pressure and thereby allowing a reduction in the interest rate) and apply conversely for a negative supply shock.

The point of the table is not only to illustrate that the effects of shocks and of fiscal policy may differ greatly according to circumstances, but more particularly to emphasise that these effects are highly conditional on the policy reaction function of the central bank. As will be seen below, this implies that the central bank, by choosing its policy strategy, may have a strong influence on the fiscal policy behaviour of governments and their incentives to engage in policy coordination.

6.2 The case for policy coordination

As a first step in the examination of the case for policy coordination, assume that the government of the home country, when deciding on its fiscal policy, is not fully informed of the plans of the government of the neighbour country but has to act on the basis of uncertain expectations. This lack of information may in itself give rise to coordination problems. For instance, assume that there are positive spillovers ($\partial Y_i / \partial G_j > 0$), and that the government of the home country believes or hopes that the other government will pursue an expansionary policy. The government of the home country may then choose a rather restrictive fiscal policy stance with a view to improving its budget balance (at a reasonable activity level), or it may adopt a 'wait-and-see' attitude in the hope that its expectations of an expansionary policy in the neighbour country are fulfilled. But if both countries act in this manner, the overall stance of fiscal policy could turn out to be insufficiently supportive of growth. This is the standard argument for coordinated or concerted reflation when lack of demand and activity is a main problem.[3] Assume next that there are negative spillovers ($\partial Y_i / \partial G_j < 0$), and that the home country expects policy in the rest of the Union to be expansionary. It may therefore itself also pursue an expansionary policy to counteract the anticipated negative cross-border effects. The outcome could be that all countries pursue excessively expansionary policies to the detriment of their common interest.

Similarly, mutual lack of information or understanding between the governments on the one hand and the central bank on the other could lead to an unsatisfactory fiscal/monetary policy mix. For instance, the central bank may expect fiscal policy to be relatively expansionary and may therefore pursue a restrictive monetary policy, while governments hesitate to take restrictive action in the fear that monetary policy will be tight. The outcome might be a policy mix which is unsatisfactory for growth and desired by nobody and yet would seem justified for each authority acting in isolation.

These 'prisoners' dilemma' problems do not necessarily call for policy coordination in a strict sense. It might be enough for the relevant decision-makers to exchange information such that all policy actors are fully informed. In fact, much of the policy coordination (notably in the Eurogroup) is devoted to exchange of information and dialogue to ensure that there is no misunderstanding with regard to the intentions among the key policy actors. There is no doubt as to the usefulness of this mutual exchange of information and views about problems and policy intentions. It is another matter whether there is a case for discretionary policy coordination in the sense that the various authorities should decide jointly on their policy instruments. This is the issue addressed next.

A systematic examination of the case for discretionary coordination calls for a comparison of two hypothetical situations. The first is one where each government separately minimises a loss function in terms of, for instance, deviations from the targets for output and the state of public finances. Such a loss-minimisation will imply a reaction function of fiscal policy under conditions of non-coordination. The second situation assumes that the two governments agree to minimise a joint loss function in the same terms; this will imply corresponding fiscal policy reaction functions with coordination. Comparing the reaction functions will indicate the effects of fiscal policy coordination.

The analysis of policy coordination along these lines is rather straightforward if one assumes the simple MF model in which fiscal expansion increases activity domestically but has no effect on output in the monetary union as a whole (because of the negative cross-border effects, see Equation (6.1)). Assume that the governments minimise, subject to Equation (6.1), the following loss functions:

$$C_i = (1/2)[(Y_i - Y_i^*)^2 + \alpha_i(G_i - t_i\overline{Y}_i)^2] \tag{6.2}$$

where it is assumed that $Y_i^* > \overline{Y}_i$ (the target level of output is higher than potential output). The optimal fiscal policies, in the absence of coordination, are characterised by the conditions:

$$G_i - t_i\overline{Y}_i = (\phi_{ii} / \alpha_i)(Y_i^* - Y_i) \tag{6.3}$$

indicating that nationally optimal fiscal policies will react to output fluctuations in a countercyclical way. This policy activism may not be helpful for the monetary union as a whole, however, since any output gain for country *i* occurs at the expense of output of country *j* (as seen above). An additional problem is that there will now be a deficit bias in the fiscal policies of the member states and the Union; this deficit bias will over time be reflected in some loss of competitiveness and a shift from net exports to domestic demand without any durable gain in the level of activity. Note that this budget deficit bias in a monetary union contrasts with the case of the SOE, where no such bias was established (see section 5.1), thus giving some justification to the concerns that gave birth to the EDP and the SGP.[4] Obviously there is asymmetry, in the sense that small countries are much more affected by the fiscal policies of large countries than vice versa. It is therefore understandable that the SGP is particularly important for the small member states.

Assume that the two governments, in order to 'internalise' these problems, agree to minimise the following joint loss function:

$$C = \sum(1/2)w_i[Y_i - Y_i^*)^2 + \alpha_i(G_i - t_i\overline{Y}_i)^2] \tag{6.4}$$

where w_i is the relative weight of country i also in the Union's loss function. Optimal fiscal policies are now given by:

$$G_i - t_i\overline{Y}_i = (\phi_{ii} / \alpha_i)(Y_i^* - Y_i) + (w_j / w_i)(\phi_{ji} / \alpha_i)(Y_j^* - Y_j) \tag{6.5}$$

which means that fiscal policy in country i reacts to output developments in both countries. Also, aggregating the policy reaction functions, and assuming at this point for convenience that they (or the countries) are identical, one finds that:

$$G - t\overline{Y} = \sum w_i(\phi_{ii} / \alpha_i - \phi_{jj} / \alpha_j)(Y_i^* - Y_i) = 0 \tag{6.6}$$

that is, there is no deficit bias (as $\phi_{ii} = \phi_{jj}$ and $\alpha_i = \alpha_j$). By coordinating their fiscal policies, the members of the Union can reduce or do away with the tendency to fiscal laxity. An alternative and much simpler way to tackle the problem of a counterproductive deficit bias would obviously be for the governments to agree to abstain from fiscal 'fine tuning' (implying $\alpha_i \to \infty$ in their national loss functions), thus keeping government expenditure constant at the level of cyclically adjusted tax revenues.

It is, in principle, possible to extend policy coordination so as to cover not only fiscal policies of the member states of the Monetary Union but also the monetary policy of its central bank. In terms of analysis, a (quadratic) inflation term could be added to the loss function, assuming this to represent the key concern of the central bank (as was done in Equation (5.5) above). It is easy to demonstrate that coordination of macroeconomic policies in this case would not be associated with any budget deficit bias. However, there would be an inflation bias if the target level of economic activity exceeded the level of potential output. As in the analysis in section 5.1, this inflation bias would not be associated with any durable gain in the level of economic activity. Assuming inflation to be bad for the economy (for reasons referred to in section 4.1.2), policy coordination between the fiscal and monetary authorities therefore risks being positively harmful. This is the main rationale for the position of the ECB, which has consistently and strongly refused to consider any ex ante coordination of fiscal and monetary policies within the Eurogroup or in other contexts (see also section 6.6).

Analysis of policy coordination is less straightforward for the more general version of the model, which allows for a wide spectrum of fiscal policy effects depending on the monetary policy reaction function and other circumstances. No clear-cut conclusions can then be arrived at. However, a taxonomic description can be made of the case for coordination, most conveniently by using Figure 6.1, which measures output of country 1 (the 'home country') on the vertical axis and of country 2 (the 'neighbour country') on the horizontal axis. Assume that the Union is originally at point *A* with actual output equal to potential output for both countries. A negative external shock then reduces output in both countries (shifting the short-term equilibrium at unchanged fiscal policies to point *B*), as would be the case for a negative *symmetric shock*. The home country may take fiscal action with a view to neutralising or reducing the effect on its level of output.

This fiscal expansion would shift the position of the Union from point *B* to point *B′* in the case where the cross-border effect of fiscal policy is positive, meaning that fiscal expansion in the home country increases output also in the neighbour country. Coordination would result in more active countercyclical fiscal policies to the mutual

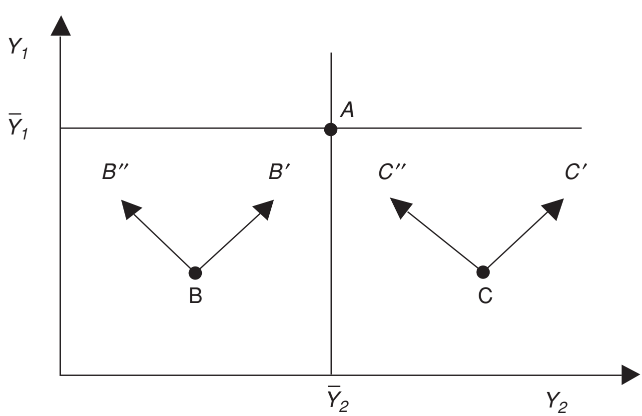

Figure 6.1 Taxonomy of policy coordination

benefit of both countries. This is the case for concerted fiscal reflation to support area-wide activity in the face of a symmetric decline in demand (and similarly there would be a case for concerted fiscal contraction in the face of a symmetric increase in demand).

Assume next that the fiscal policy spillover or cross-border effect on output is negative, and that fiscal action will bring the Union to point *B″* rather than *B′*. Fiscal expansion of the home country will now improve its situation but will add to the output loss for the neighbour country. Coordination, by internalising the cross-border effects, would in this case serve to constrain policy activism (which otherwise is excessive for the Union as a whole). Avoiding uncoordinated policy responses is important, notably if the negative spillovers are significant, implying that fiscal policy has a beggar-thy-neighbour character.

The case for policy coordination (whether in favour of policy expansion or contraction) is significantly weaker if stabilisation in the face of the shock is provided by monetary policy. This would indeed seem appropriate since the shock is symmetric and as a shift towards a more expansionary monetary policy will be beneficial to both countries. The case for monetary rather than fiscal policy action is particularly strong for demand shocks, as these do not give rise to any conflict between price and output stability. Conversely, an overly passive monetary policy in the face of symmetric demand shocks risks leading to excessive fiscal activism; some monetary stabilisation may be helpful in itself as well as by relieving political pressure for government action.

Assume next that the Union is hit by an *assymetric shock* shifting its short-term equilibrium from point *A* to point *C*. There are again two subcases to consider. For the case of negative spillovers, fiscal action will shift the Union from point *C* to point *C″*. Countercyclical policies pursued by the countries on their own will now be appropriate also for the Union as a whole. They are not a problem because the cyclical situations are different. (The negative spillover of fiscal expansion in the home country is welcome for the neighbour country as it is confronted with a problem of overheating.) In fact, the case for coordination may disappear entirely if each country pursues a vigorous countercyclical policy in response to asymmetric shocks. The wisdom of policy activism may be put into question, but in this case it is not the external dimension which raises concern. The conclusion is again reversed if the spillovers are positive such that fiscal expansion in the home country brings the Union to point *C′* rather than *C″*. Coordination would now call for a fiscal policy that is less countercyclical than under non-cooperation, as the positive spillovers will not suit the cyclical situation in the partner country. It may be noted that expansionary monetary policy does not resolve the difficulty as it would be appropriate from the point of view of the home country but not for the neighbour country.

The analysis above confirms the (unsurprising) conclusion that policy spillovers imply a potential case for policy coordination. Depending on circumstances, coordination may call for less rather than more discretionary policy action in response to shocks (as compared to non-cooperation). However, what really merits emphasis is the fact that there are several cases in which no discretionary coordination at all is called for. First and most obviously, no coordination is called for if fiscal policy spillovers are small. This may be the case, for instance, because the direct demand effects and the consequences of the financial repercussions (broadly) offset each other. Second, there is no case for fiscal policy activism nor for coordination if decision-makers adopt the doctrine which recommends keeping cyclically adjusted budgets close to balance and using fiscal policy only in the form of the automatic stabilisers. Third, asymmetric demand shocks may often be properly dealt with by decentralised fiscal policies; a strongly countercyclical fiscal action in the face of a country-specific shock should serve to insulate the partner country from repercussions. Fourth, symmetric demand shocks do not call for fiscal policy action nor coordination but for changes in monetary policy to keep total demand at the level of potential output.

Also, policy makers are unlikely to have reliable information on the shocks or the size (or even sign) of the policy effects, notably with regard to the cross-border consequences. Such ignorance is not a comfortable basis for practical conclusions on policy coordination. The importance of these considerations is such that the case for discretionary coordination loses much of its significance. Instead, these observations conform with the view of Buti and Sapir (1998) that there is a natural division of labour: *monetary policy should focus on area-wide stabilisation while fiscal policy may alleviate the effects of country-specific disturbances*. This amounts to a policy based on assignment rather than discretionary coordination (see section 6.6).

A key feature of the analysis above is that there is no discretionary coordination as between monetary and fiscal policy. Instead, it is assumed that the central bank is committed to an announced policy strategy or rule. This approach[5] serves to bring out the importance of the monetary policy strategy for the incentives of fiscal policy decision-makers. In particular, a relatively non-accommodating monetary policy (strongly geared to price stability) will reduce the effectiveness of fiscal policy with regard to output and contribute to making its cross-border effects negative. The reduced effectiveness of fiscal policy (as compared to the case with a more accommodating monetary policy) should reduce the incentives to fiscal activism and also reduce the budget deficit bias. It is, in this light, indeed important that monetary policy should be geared to price stability by keeping the level of output close to potential for the monetary union as a whole. A perception that monetary policy is overly passive will incite governments to (problematic) fiscal activism, with or without coordination, while an expectation that the central bank aims at stabilisation allows governments to give more weight to fiscal consolidation. In other words, monetary and fiscal policy are partly subsitutes, and the fiscal policy reactions should be an important consideration when designing the monetary policy strategy.

6.3 The adjustment process

The analysis above focuses on the short-term effects of shocks and policies. Relative price changes play no role, being in the short term either unchanged or without real effects (because of time lags). Over time, however, adjustment through relative prices is essential for a monetary union to function satisfactorily. In this section it is assumed that adjustment takes place gradually as price levels in the two countries react to their respective output gaps (and the permanent exchange rate adjusts towards the actual rate). In long-term equilibrium, relative prices will be such as to allow actual and potential output to be equal and prices stable.

To simplify analysis of the adjustment process, it will be assumed that the monetary policy of the central bank is fully non-accommodating, the central bank keeping the overall price level stable by standing ready to adjust the interest rate as required (implying $k_P \to \infty$ in (5.12)). With some further assumptions (see Annex), the adjustment process can be described by Figure 6.2, which shows the actual and potential output of the home country (vertical axis) and of the neighbour country (horizontal axis). Under the assumptions made, the level of total demand and output in the union must be on the curve *PP*, which shows the combinations of output in the two countries compatible with price stability in the union as a whole. At any point on *PP* above point *A*, the price level in the home country is rising and prices in the neighbour country falling, while the reverse holds for points on *PP* below point *A*. Obviously, long-term equilibrium is at point *A*.

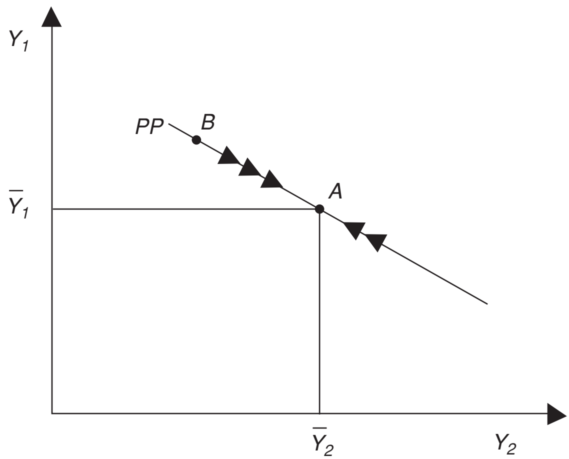

Figure 6.2 The adjustment process

Assume that the Union is initially located at point *A* and that the home country undertakes fiscal expansion. The central bank will raise the interest rate to offset the overall effect on demand at the level of the Monetary Union as a whole. Yet the fiscal stimulus will reallocate demand in favour of the home country and the short-run equilibrium will shift to point *B*. However, this short-term equilibrium at *B* is characterised by excess demand for output in the home country and excess supply in the neighbour country, and the relative price of home country goods will therefore start increasing.

The rise in the relative price of home country output will reallocate demand in favour of the neighbour country, thus shifting the short-term equilibrium of the Union downwards on the *PP* curve. The adjustment process continues until the economy is back at point *A* (now with a higher relative price of home goods to offset the demand effect of the more expansionary stance of fiscal policy). Alternatively, assume that an asymmetric shift in (private) demand shifts the Union from *A* to *B*. Instead of waiting for the adjustment through relative prices to occur, fiscal policy might then rectify the situation and shift the economy back to point *A* (by fiscal expansion in the neighbour country and/or contraction in the home country).

Assume next that the *PP* curve were to shift inwards (with equiproportionate output effects for the two countries) and be located as PP_1 in Figure 6.3, point *B* now representing the equilibrium for which the relative price P_1/P_2 is constant. This deterioration in the economic situation could be due to, for instance, a negative supply shock that requires a rise in the interest rate to maintain price stability, or it could reflect a monetary policy that, by mistake, is more restrictive than needed for price stability. There is now a dilemma for both countries: the home country may undertake fiscal expansion to shift the economy from a short-term equilibrium at point *B* to point *C* and thus raise its short-term level of activity. This would be at the expense of activity in the neighbour country, however, which might pursue fiscal expansion to shift the economy from point *C* to point *D*. Such attempts at fiscal reflation would be futile 'beggar-thy-neighbour' policies because their Union-wide effects would be neutralised by further monetary tightening. It would clearly be desirable for both countries to abstain from fiscal expansion either through a coordinated decision (cf. section 6.2) or because of the constraints of the SGP (cf. section 6.6).

Also, both governments might be inclined to urge the central bank to ease its policy, to shift the *PP* curve outwards towards PP_0, arguing

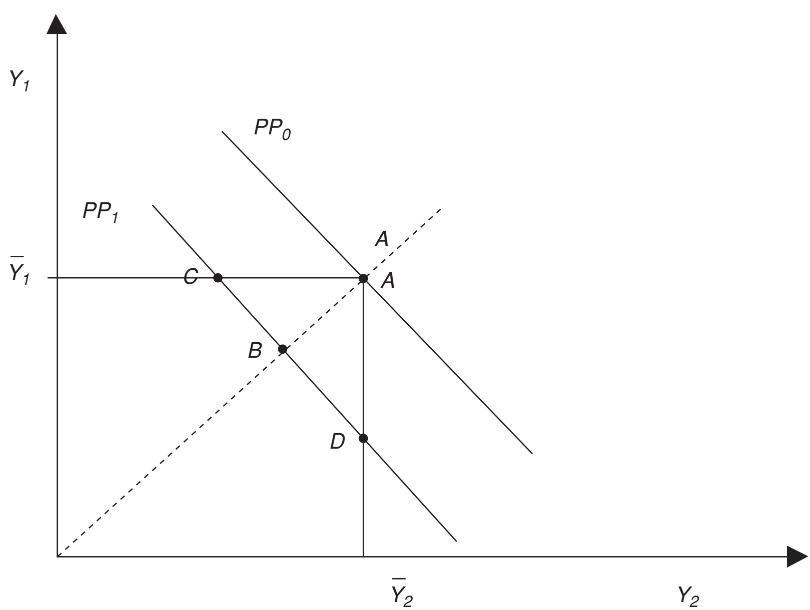

Figure 6.3 Deflationary dilemma

that monetary policy is tighter than needed for price stability (at least from the medium-term perspective, in which the negative supply shock may have ceased to operate or may be reversed). Conceivably, the central bank might accept that price rises will temporarily overshoot the target. Alternatively, it could reply by arguing that monetary loosening would only serve to raise inflationary expectations and inflation (leaving the *PP* curve unchanged), and it might insist on structural reforms to increase flexibility with a view to alleviating cost and price pressures. In any case, a combination of generalised recession and cost-push inflation pressure clearly risks giving rise to tensions between a central bank committed to price stability (by, if need be, high interest rates) and governments having growth and employment ambitions high on their political agenda.

Another problem is illustrated in Figure 6.4. Assume that the Union is located at point *E*, but that the prevailing excess capacity (unemployment) in the neighbour country does not lead to any decline in costs and prices. This means that point *E* would be an equilibrium in the sense that price stability prevails in both countries and in the Union, and relative prices would thus also be constant.[6] Yet, point *E* would be associated with an output gap in the neighbour country as a consequence of the downward rigidity of costs and prices (in that country). The situation would be still worse if, as one might speculate, excess capacity and unemployment over time affect the capital stock and the quality of the labour force, and therefore potential output, negatively (an effect referred to as 'hysteresis'), inducing $\bar{Y}_2$ to shrink gradually (towards actual Y_2). What could be done?

Fiscal expansion by the neighbour country could give some relief. Assuming that a rising activity level in the neighbour country does not trigger inflation (sticky prices), the location of the Union could shift from point *E* to, say, point *F*. The route to fiscal expansion might be blocked, however, if it leads to a budget deficit incompatible with the provisions of the SGP (cf. below). This would reflect an unbalanced mix of demand with too much of it depending on fiscal policy and too little private domestic demand and net exports.

Assume next that the central bank, facing a situation in which the Union is locked into an unfavourable equilibrium at point *E*, decides to pursue an expansionary monetary policy, lowering the interest rate (shifting the *PP* curve outwards from PP_1 to PP_0). The new short-term equilibrium is at point *H*, where there is still excess supply in the neighbour country (with a constant price level) and excess demand in the home country (with rising prices). The induced inflation in the

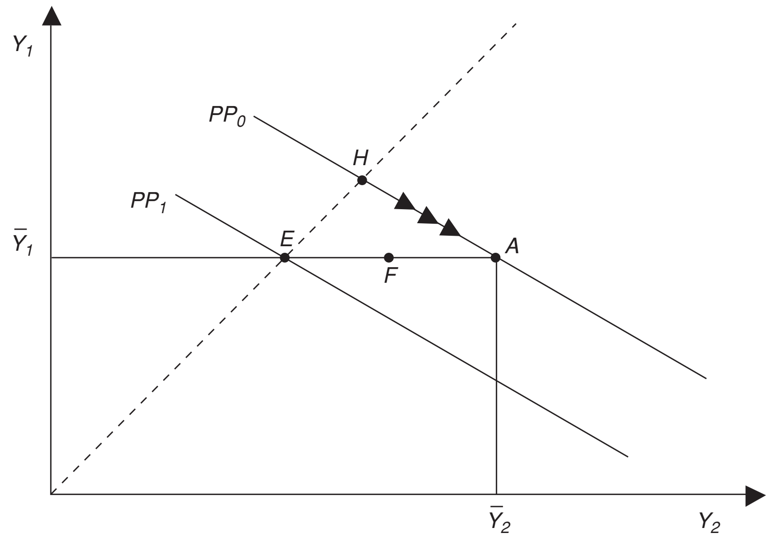

Figure 6.4 Adjustment with price rigidity

home country would raise its relative price level, gradually shifting the economy towards the (favourable) equilibrium at point *A*, where price stability would prevail again. This case has the remarkable characteristic that a temporary dose of monetary expansion and inflation helps to achieve a permanent increase in the level of activity. It does so by facilitating a needed change in relative prices which is difficult to achieve with full respect for price stability because of downward rigidity of costs and prices in a part of the Monetary Union. There is in this case a genuine trade-off between output and inflation, a trade-off which might obviously give rise to differences of views between monetary and fiscal authorities with regard to appropriate policies. In particular, downward nominal rigidity may be invoked as an argument for defining price stability so as to be consistent with some (low) inflation rather than requiring a strictly constant price level (Box 6.2). An important caveat, however, is that the temporary price rises (in the home country) must not trigger a rise in inflation expectations. This is conceivable, given that price stability will prevail again once the adjustment process has worked itself out, but cannot be taken for granted and presupposes a strong credibility of the central bank.

Some conclusions that emerge from this analysis are as follows: first, it is the task of monetary policy to keep overall demand at the appropriate

Box 6.2 The ECB definition of price stability

The treaty instructs the ECB to aim at price stability but does not define that objective. The ECB has set itself the objective to keep the annual increase in the (harmonised) consumer price index below (but close to) 2 per cent in the medium term. This is an ambitious goal, and there are some reasons why it might be too ambitious.

First, quality improvements are to some extent reflected as price increases because of measurement difficulties. Second, the process of catching up by poor countries through rapid productivity growth may give rise to some inflation in the non-traded goods sector without significantly undermining price stability in EMU (the 'Balassa effect'). Third, downward wage rigidity may make it difficult to achieve changes in relative prices in conditions of very low overall inflation (as seen above). In fact, relative price changes will then call for no inflation or even falling prices in countries that need to improve their competitive position. This risks leading to particularly high real interest rates precisely in those countries which, because of weak competitiveness, suffer from low growth and high unemployment (a situation recently prevailing in Germany).

While views differ on the relevance of these considerations, it may also be noted that the ECB has *de facto* allowed actual inflation to exceed the ceiling somewhat for most of the time. This may amount to an (implicit) recognition of the problems of setting too ambitious a target for price stability.

level in the Monetary Union as a whole (the position of the *PP* curve). Second, fiscal policy may be used to counter the effects of temporary asymmetric shocks (movements along the *PP* curve). Appropriate fiscal policy responses are facilitated (can be achieved without coordination) if the stance of monetary policy is 'right'. Third, fiscal policy cannot deal with permanent (asymmetric) shocks as these require changes in relative prices to ensure compatibility of sound public finances with economic activity at the level of potential output. Fourth, downward flexibility of costs and prices may be called for if significant changes in relative prices are to be consistent with a very strict target for price stability. Alternatively, economies hit by asymmetric shocks face the risk of protracted adjustment difficulties.

6.4 Does EMU need a stabilisation fund?

Assume that the price mechanism is inflexible and that there is little that governments can do about it. As a matter of second best, one may then ask whether there are other actions which could help to cope with shocks. One strand of thought is that problems would be easier to deal with if EMU were equipped with a strong central government with a big federal budget. This would imply EMU-level automatic stabilisation, and would conceivably also allow discretionary action by the federal authorities with a view to helping individual member states to overcome their adjustment problems. Be that as it may, the setting up of an 'economic government' for EMU with substantial political power and financial resources is an unlikely development in the foreseeable future.

However, there is also a simpler scheme which, it is occasionally argued,[7] could give member states some insurance against the macroeconomic risks associated with asymmetric shocks. In particular, member states could agree to set up a central 'stabilisation fund'. Basically, each member would contribute resources to the fund during 'good years' and would correspondingly be in a position to draw on it in 'bad years'. The essence of this idea may be illustrated in a simple manner by using Figure 6.5, which shows the level of output (horizontal axis) and the cyclically adjusted budget surplus (vertical axis) of a (representative) member state in the Monetary Union.

Assume that this member state faces a trade-off, such as in QQ_A or QQ_B, between the level of output and the structural budget deficit. In other words, the government can increase the level of activity by

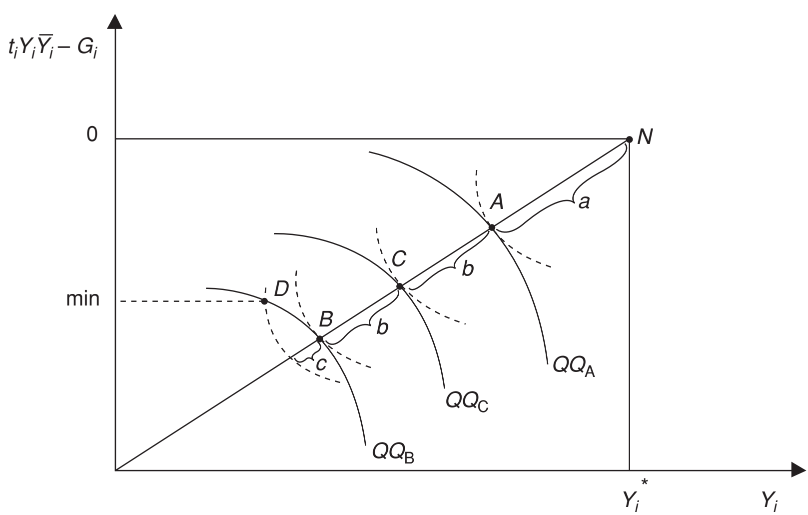

Figure 6.5 The benefits of a stabilisation fund

expansionary fiscal policy, but only at the cost of a deterioration in the cyclically adjusted budget deficit. It is assumed that an increase in the structural budget deficit reduces the effectiveness of fiscal policy and thus the trade-off is non-linear (though this is not central to the argument). Assume further that the member state is subject to changing fortunes in the form of export fluctuations such that the trade-off alternates between QQ_A and QQ_B. Depending on the location of the trade-off curve QQ, the government sets its policy so as to be at point A or B, these being points of tangency of the trade-off curves with indifference curves of the government (dotted).

Envisage now a central stabilisation fund, to which the member state would contribute, during good years, an amount equal to half of the vertical distance between QQ_A and QQ_B, and from which it would receive the corresponding amount during bad years. The effect would be that the trade-off would always be QQ_C, and the government would then set its policy so as to stay at point C.

It is straightforward to show that the loss associated with point C is smaller than that of the average of positions alternating between A and B. Noting that N is the 'point of bliss' and assuming that the loss is quadratic[8] in the distance from N, point C is to be preferred to alternations between A and B if

$$(a+b)^2 < [a^2+(a+2b)^2]/2 \tag{6.7}$$

which is indeed the case: smoothing or insurance in the form of risk-sharing is beneficial. (This obviously presupposes that the macroeconomic risks in the union are asymmetric such that the aggregate risk can be reduced by pooling individual risks.) Assume further that a location at point B would violate the deficit ceiling, and that the government would therefore have to tighten its budget during the bad years, with the consequence that the economy would end up at point D. This would imply an additional and potentially significant cost (measured by c in Figure 6.5), which arguably strengthens the case for the stabilisation fund. There is thus a case for a central stabilisation fund to give insurance, helping to smooth output developments and to avoid being constrained during bad years.

Yet the idea also raises a number of serious difficulties: in particular, it would be difficult to ensure that the scheme is neutral in the sense of not giving rise to any permanent redistributions between member states. If neutrality is ensured, however, then the scheme largely amounts to a special borrowing window. The need for such a lending facility is questionable, as governments can easily borrow on financial markets during the bad years as long as they run surpluses during the good years. The budget deficit ceiling of the SGP may indeed pose a problem, but this is less an argument for setting up a stabilisation fund than for interpreting the SGP with sufficient flexibility (or, possibly, for modifying its provisions). Finally, the stabilisation fund would give rise to serious problems of moral hazard by making fiscal deficits seem a more attractive option, changing the perceived trade-off in fiscal policy. It would be likely to reduce the incentives of governments to budget discipline and structural reform by creating expectations of a 'bail-out' in the case of difficulties. As a matter of practical policy this proposal may be deemed a non-starter, because a positive decision would require unanimity among member states (such unanimity not being a realistic scenario). Action to strengthen EMU should rather focus on structural reform and flexibility (Box 6.3).

Box 6.3 An aside on structural policies

Is there a 'common interest' of member states to pursue structural reforms so as to raise potential output and to enhance flexible price adjustment with a view to making EMU function properly? While long-term growth and potential output may depend mainly on action within the member state concerned (such as investment in physical and human capital), there are also several elements of common interest which merit attention:

First, an increase in potential output in the neighbour country will reduce the relative price of its output, thereby improving the terms of trade of the home country. Thus, the home country stands to benefit from productivity growth in the neighbour country in the form of lower import prices. Second, an increase in potential output will reduce inflationary pressure and will allow a reduction in interest rates in the Union in the short to medium term. Third, structural reform which enhances price flexibility reduces the risk of getting locked into unfavourable equilibria (of the kind considered above), of hysteresis and of difficult policy trade-offs between the level of activity and price stability. Thus, policy authorities in the Monetary Union have a common interest in the functioning of labour and goods markets, of wage and price formation.

However, at least two caveats are in order: first, structural problems are often deeply rooted in country-specific institutional circumstances and solutions will have to be formulated and implemented nationally. Common guidelines are of limited value and may be unduly influenced by member states seeking to delay reform rather than speed it up. Second, one may question the need for concerted action since member states do have incentives to tackle their structural problems; they are themselves their prime victims. A country with downward wage rigidity may to some extent be a problem for the Union as a whole, but it is above all the country itself which will suffer from high unemployment and which stands to gain from action enhancing flexibility. There is no clear need for international coordination, rather for encouraging healthy competition between member states.

Also, the need for flexibility in EMU should not be exaggerated; nominal rigidities will give rise to policy problems whatever the exchange rate regime. It is debatable whether a floating exchange rate will, in practice, serve to insulate an economy from asymmetric shocks and problems of competitiveness, or whether it will rather be more vulnerable to capital account disturbances and instability. Given the long and uncertain time lags, monetary policy is at best a very imperfect instrument for fine tuning. As stressed by Buiter (1999), the requirements of labour market flexibility may not be all that different in a monetary union as compared to an SOE with a floating exchange rate.

6.5 Debt dynamics and the SGP

Discretionary policy coordination is fraught with difficulties (as stressed in section 6.6). This makes it attractive to look for rules safeguarding the common interest related to spillovers while allowing for decentralised decision-making. This is the purpose of many of the provisions in the treaty, notably of the Excessive Deficit Procedure (EDP), and of the Stability and Growth Pact (SGP). To get a perspective on the aim and role of the constraints on fiscal policy behaviour set out in these fiscal policy rules, it is useful first to analyse the dynamics of government debt.

6.5.1 Sustainability of public finances

Consider an individual member state of a large monetary union, implying that the member state under consideration is small enough for the interactions with the rest of the union to be of negligible significance. The budget deficit of the country may be written:

$$B = \dot{D} = G - tY + RD \tag{6.8}$$

where D is the stock of public debt which increases over time according to the size of the budget deficit. The budget balance is a positive function of the level of income (via tax revenues) and is negatively affected by public expenditure and debt service payments. It is assumed that the level of output may be written as:

$$Y = \phi(\underset{+}{G}, \underset{-}{R}, Z) \tag{6.9}$$

that is, it depends positively on the fiscal policy instrument and negatively on the rate of interest, while Z is a vector of other variables influencing output. Assume further that the interest rate in the country is equal to the interest rate prevailing in the monetary union, R_{ε}, plus a possible risk premium associated with less than full confidence in the sustainability of its public finances:

$$R = R_{\varepsilon} + \underset{+}{\rho}(D) \tag{6.10}$$

The risk premium is now assumed to be a positive function of the level of debt rather than of the budget deficit.[9] Also, it is assumed that the government is minimising a loss function that is negatively affected by deviations of output from its target level as well as by structural budget imbalances and a high level of public debt. As shown in the Annex, fiscal policy may then be characterised by the reaction function:

$$G - t\bar{Y} = (\phi_G/\alpha)(Y^* - Y) - [R + (\beta/\alpha)]D \tag{6.11}$$

in which government expenditure is negatively affected by the level of output (reflecting countercyclical ambitions) as well as the stock of debt (reflecting public finance ambitions).

It is straightforward to show that the dynamics of public debt can be examined with the help of Figure 6.6, with the stock of public debt on the horizontal axis, and the interest payments on government debt as well as tax revenues less government expenditure on goods and services (also referred to as the primary budget surplus) on the vertical axis. As seen from Equation (6.8), the stock of debt will be increasing if there is a budget deficit, which is the case if interest payments exceed the primary surplus. Interest payments will rise in line with the stock of debt, and the slope of the relation will increase if rising debts add to the risk premium ($\rho' > 0$), which may be the case particularly at high levels of debt. The primary surplus also increases with the stock of debt, as fiscal policy reacts to the additional debt burden, but the pace of increase may be gradually declining (see Annex).

It is possible that the model will have two (or more) equilibria, represented in Figure 6.6 by points S and U. The latter equilibrium is unstable: interest payments exceed the primary surplus at any level of debt to the right of point U (implying a budget deficit and further increases in the debt level), while interest payments are smaller than the primary

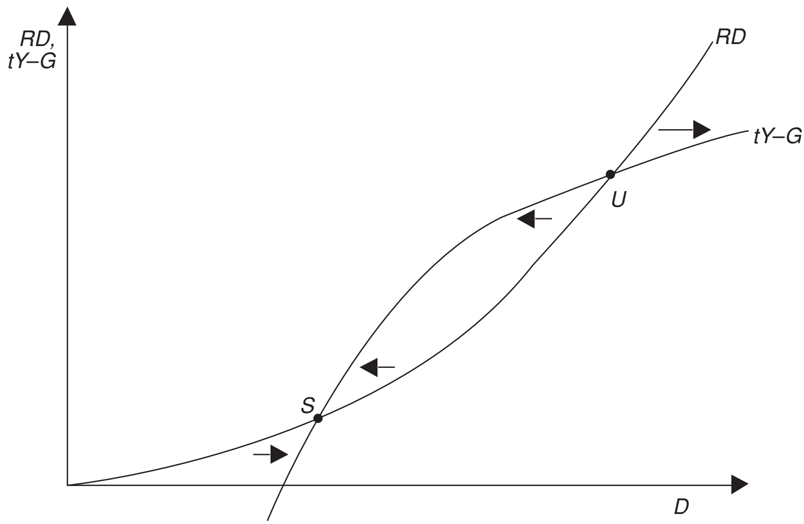

Figure 6.6 Public finance sustainability

surplus for debt levels smaller than at point *U* (implying a budget surplus and a declining debt level). A similar inspection will demonstrate that point *S* represents a stable equilibrium.

The point of the diagram in Figure 6.6 is to demonstrate the risk of instability in public finances. Such a risk is particularly relevant if the stock of debt is allowed to become very large, if there is a sudden shift in the level of the risk premium (loss of confidence in the commitment of the government to sound public finances), if there is a sharp decline in the level of output, and/or if there are political constraints on the scope for reductions in fiscal expenditure (or tax increases) with a view to improving the budgetary situation. While the analysis covers only the case of an individual member state of EMU, it should be obvious that there are spillovers and that lack of stability in one member state would risk accentuating similar problems in other member states.

Positions close to the stable equilibrium *S* (with confidence in 'sound public finances') are obviously far better than positions in the region of the unstable equilibrium *U* (with acute concern about unsustainable public finances and high risk premia). It is therefore valuable if there are mechanisms that serve to keep the economies in the region close to

S with a relatively low debt level. There are basically three candidates for this function.

First, public finances will not become a policy problem if governments are sufficiently prudent (as governments democratically elected by rational citizens should be). Reluctance to allow any serious deterioration of the structural deficit and debt positions would ensure convergence to a stable equilibrium *S*. The presumption that fiscal policies are such as to preserve debt sustainability might seem obviously justified for EU member states. However, governments may not be very prudent if short-term electoral prospects call for expansionary measures,[10] taking into account also that future generations (who bear much of the burden of budget deficits) are under-represented in the democratic process. Public choice theory points to various distortions which may imply that the political process generates 'excessive' deficits and debts. Public debts have in some cases reached high levels (above 100 per cent of GDP) and, more importantly, the consequences for public finances of ageing populations are a serious source of concern. As was seen in section 6.1, EMU may aggravate the fiscal deficit bias as borrowing by individual governments has only small effects on the area-wide level of interest rates (allowing 'free riding').

Second, structural deficits may affect national risk premia and could thereby lead to a differentiation of interest rates as between member states in the monetary union. This would reduce the spillovers and should give better incentives to governments in their decision-making. However, it is widely felt that this mechanism is unreliable. Financial markets, it is thought, tend to react very late (allowing sizable budget deficits to go on for a long time) and then abruptly. This presumption of financial markets reacting too little or too late explains the suspicion that a financial crisis of a member state might have union-wide consequences for policies. It could call for cooperative action by governments (in spite of the no-bail-out clause in the treaty) and/or it could undermine the stability orientation of monetary policy. It is therefore thought that undisciplined policy of one country may affect confidence, the value of the currency and the level of interest rates in the union as a whole, hence the problematic spillovers.[11]

The third possibility is that the governments of the member states in the monetary union enter into agreements with a view to strengthening budget discipline and reducing the risk of ending up on an unsustainable debt path. This is the purpose of the fiscal policy framework of the EMU, notably the EDP and the SGP.

6.5.2 The Stability and Growth Pact

There are basically two parts in the fiscal policy framework[12] in EMU: a 'soft' part and a 'hard' part. The soft part uses peer pressure with a view to encouraging member states to maintain sound public finances. In particular, member states should seek to achieve general government financial positions of close to balance or surplus in the medium term as well as low or declining public debt levels (as a share of GDP). The hard part of the SGP is the EDP provision (itself in the treaty), according to which member states in EMU have a legal obligation to avoid excessive deficits and may have to pay a fine if their general government financial deficit exceeds the reference value of 3 per cent of GDP or debt levels are too high.

The intention is that the SGP should contribute to stability of the government debt dynamics. Is there a clear presumption that it will indeed do so? It is easy to demonstrate (see Annex) that the system will necessarily be stable if the response of government expenditure to the level of debt (indicated by the parameter β) is strong enough. However, the level of government debt is in fact not the key variable focused upon in the practical implementation of the SGP; much more attention is given to the size of the budget deficit. It is less obvious that this helps government debt stability. To see this most simply, assume that fiscal policy were always to maintain a balanced budget in cyclically adjusted terms. In this case, there is no discretionary policy but automatic stabilisers are allowed to operate fully, which amounts to a rule which seems prudent and reasonable (avoiding the risk of procyclical policy). However, such a rule in itself is not enough to ensure debt sustainability. A policy geared to budget balance would at best be neutral in the sense of always aiming at stabilising the government debt at whatever level it may have reached as a consequence of events in the past (but would not be stable in the sense of convergence to an equilibrium).

It should at this point also be recalled that one of the key rules is not formulated in terms of cyclically adjusted budget deficits. In fact, the sanctions mechanism is operative (if at all) only for actual budget deficits exceeding 3 per cent of GDP (even then with exceptions), is conditional on a decision by the Council, and is associated with a cap (such that the fine never exceeds 0.5 per cent of GDP). Since the fine is triggered when the actual budget deficit exceeds the ceiling, the SGP is conditional on the cyclical situation rather than on structural or underlying budget developments. This feature of the SGP has become a main target for criticism[13] on the grounds that a fiscal policy geared to actual budget balance is inherently and systematically procyclical: any change in the level of income and therefore tax revenues would trigger an equivalent change in government expenditure (as $G=tY–RD$), thus aggravating short-term macroeconomic fluctuations.

To illustrate this line of criticism, consider Figure 6.7, which shows the level of output and income, Y, on the horizontal axis, and the budget deficit B on the vertical axis. The downward sloping BB-line shows that the budget deficit is a decreasing function of the level of income (via tax revenues). The upward sloping line YY (which is derived by using Equations (6.8) and (6.9)), shows the combinations of level of income (Y) and budget deficits (B) which can be attained for various levels of the fiscal policy variable (government expenditure). The curve YY thus shows the policy trade-off between the level of activity and the government's budget. A higher level of income can be achieved by using expansionary fiscal policy, but only by accepting a worsening of the budget position as indicated by the curve YY.

Assume that the economy is originally at point A with income at Y_0 and the budget deficit B_0, and that an exogenous reduction in total demand (e.g. a fall in exports) then shifts the YY curve to the position YY'. What is the implication for the level of income? This will depend on the fiscal policy pursued. The new equilibrium will be at C_A if *fiscal policy stays unchanged*. The budget deficit will increase to B_A while the level of income declines to Y_A. This case of 'neutral' or constant fiscal policy amounts to accepting the weakening of the budget balance

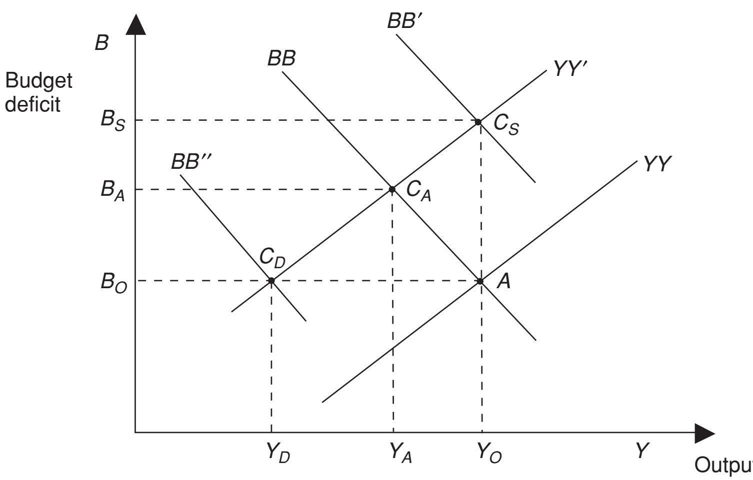

Figure 6.7 Output stabilisation and the budget balance

caused by falling tax revenues, that is, from allowing the automatic stabilisers to operate. The government may also undertake countercyclical fiscal policy to dampen the decline in activity. It could even keep *the activity level unchanged* at Y_0 by fiscal expansion shifting the *BB* curve to the extent that it crosses the *YY* curve through point C_S, but this would substantially increase the budget deficit. Alternatively, the government could keep the *budget deficit unchanged* by contractionary fiscal policy shifting the short-term equilibrium to point C_D, but this would be at the cost of a weaker level of activity.

The SGP cannot be blamed for the fact that a negative shock will pose a dilemma for the government in its economic policy, imposing upon it the need to choose between bad alternatives. However, the SGP may imply, if the country is already close to the 3 per cent deficit ceiling, that the government has no room for manoeuvre to undertake countercyclical measures, and it may even create a situation in which the government cannot allow the automatic stabilisers to operate, but will have to undertake contractionary fiscal measures which intensify economic weakness. While few economists today plead for Keynesian fiscal policy activism, there is rather broad consensus on the desirability of allowing automatic stabilisers to operate. The fact that the SGP may become a straitjacket which does not allow for this, and which may call for procyclical action with negative implications for economic activity during a recession, is therefore a source of concern.

However, this criticism is arguably unfair to the SGP. The SGP does not prevent governments from using economic upswings (wisely) to consolidate their public finances but rather encourages them to do so; a rise in tax revenues does not call for an increase in expenditure but can be used to strengthen the budget position. Acting prudently in economic upswings, governments would be better placed to meet the budgetary consequences of downswings. In particular, the SGP only sets a ceiling; member states should in normal times strive to achieve a sufficient safety margin so as to be able to allow their budget balance to deteriorate in a recession (because of the automatic stabilisers and/or discretionary fiscal action). Nevertheless, the SGP may become problematic for a country close to the deficit ceiling. In particular, an abrupt deterioration of the economic situation or a prolonged recession may, by raising the recorded budget deficit, confront the government with an additional constraint on its fiscal policy precisely at a time when it would be important to allow the automatic stabilisers to operate fully (if not to undertake some discretionary fiscal policy measures to support demand and activity).

Box 6.4 The difficulty of living with rules

France and Germany (F&G) were running excessive deficits in 2002, and were therefore given recommendations under Article 104(7) to bring the situation to an end in 2004 at the latest. In October 2003, it was clear that this would not happen; F&G were foreseen to have excessive deficits in 2004 for the third year in a row. There was broad agreement that F&G would need more time (until 2005) to correct their deficits, but also that they should undertake more fiscal adjustment in 2004 than foreseen in their budgets. While the size and timing of the required fiscal consolidation was the subject of some debate, it was really the procedure that became the sticking point.

The Commission recommended to the Council to 'give notice' under Article 104(9) to F&G to take the measures judged necessary by the Council to remedy the situation. F&G considered that this would bring them dangerously close to possible decisions on sanctions, and mustered a blocking minority to prevent the decision. F&G wanted the Commission instead to give a new recommendation under Article 104(7), which the Commission refused. Given the deadlock, the Council agreed on political conclusions as a substitute for formal decisions effectively putting the normal procedure on hold.

The failure of the Council to apply the 'proper' procedure was heavily criticised by the member states being outvoted, the ECB, and many media, and it certainly dealt a serious blow to the credibility of the SGP. Also, it created a rift between small and large member states, the former feeling that the rules were not implemented equally. The Commission decided to bring the matter to the ECJ to clarify the legal status of the procedure and to annul the conclusions of the Council.[14]

The incident illustrates both the economic and the political difficulties of the SGP. Given three years of stagnation and a weak economy, it arguably did not make sense to ask F&G to make big cuts in expenditure or tax increases. Politically it is close to inconceivable for the Council to impose fines and expect authorisation of their payment by the parliaments in F&G. Rules are useful, even essential, but there must inevitably also be discretion, and rules need to be backed up by political will and skilful implementation.

There is by now an academic literature[15] on possible ways to amend the SGP or to replace it with alternative arrangements. Some of the proposals suggest amending the rules. For instance, it has been suggested that calculations of the general government financial position for the purposes of the pact should exclude public investment (which is arguably less of a burden on future generations than current consumption), or that the 3 per cent reference value should be defined in cyclically adjusted terms. One problem with these proposals concerns the reliability of the figures: the distinction between public consumption and investment is not always very clear, and the assessments of structural or cyclically adjusted budget deficits is associated with severe methodological problems (compared to using the nominal or actual deficit as recorded in the System of National Accounts).

Another group of proposals focuses on ways of enhancing budget discipline in upswings. This aim is motivated by the observation that fiscal laxity in the good years is a main reason for the difficulties of complying with the pact (without procyclical fiscal action) in recessions or periods of weak growth. Calmfors (2003) among others suggests setting up 'rainy day' funds, the idea being that such public funds should be built up during upswings. The SGP would be modified so as to allow deficits beyond 3 per cent of GDP to the extent that these are financed by drawing on these rainy day funds (accumulated during the good years for the specific purpose of having more leeway during the bad years). Also, it has been suggested that the acceptable budget deficit should be linked to the level of public debt. In fact, the debt variable figures importantly in the treaty article on the EDP (Article 104), and it would be only natural to give it greater weight in the implementation of the rules.[16] However, it would be important also to take account of off-balance items such as unfunded pension liabilities, given their role for the long-term sustainability of public finances.

A further category of proposals suggests doing away with rules and opting instead for a 'Sustainability Council' of fiscal experts at EU level with wide-ranging powers to overrule or veto decisions of national governments and of the Ecofin Council. As stated in Fatas *et al.* (2003: 7), politicians are not well placed to implement fiscal discipline properly as this amounts to a situation where 'sinners judge the performance of fellow sinners'. It may be argued that fiscal rules do not allow the necessary reconciliation of discipline and flexibility. The analogy with the ECB may be drawn upon to suggest the possibility of delegating power to an independent body of fiscal policy experts. While having its merits, this proposal seems to be outside the realm of political realism. Also, the analogy with monetary policy may be misleading as fiscal policy is much more complex and as it might be extremely difficult to disentangle the technical aspects from the political decisions.

It is certainly inconceivable that decisions on the size of the public sector or on the overall tax rate would be delegated to experts, as these decisions are linked to fundamental choices about the role of the public sector. Similarly, the size of the general government financial deficit has important consequences for the intergenerational distribution of income, again a highly political matter which can be decided only by the political system. Calmfors (2003) suggests that the parliament, at the national level, would decide on the budget deficit over the medium term, leaving it to a national fiscal policy expert committee to decide on variations in the budget deficit over the cycle. This should help avoid a procyclical bias and fiscal expansions timed according to electoral cycles. However, there are numerous measures which may be used to adjust budget developments, and the various actions are far from neutral with regard to their incidence and distributional consequences. Also, it would be difficult to define in advance (by the Parliament) the instrument to be used, as varying circumstances might call for different responses.

In all, the proposal to delegate the cyclical aspect of fiscal policy to expert committees, be it at the level of the Community or at the level of member states, is doomed to remain a matter for academic debate rather than practical policy. A more modest and politically palatable proposal is the suggestion to set up fiscal policy expert committees to advise governments of member states on how to combine fiscal discipline with some flexibility according to the economic situation. However, this suggestion does not add much to what is already in place in many countries (expert bodies such as groups of wise men) or at the level of the EU (where advice and monitoring is one of the functions of the Commission and expert committees).

The analysis in section 5.1 suggests that a key element of any reform of the fiscal rules should be to anchor them in the concept of sustainability of public finances. This would need to be made operational so as to allow evaluation and peer pressure to be exercised. In doing so, account needs to be taken not only of the level and trend of the public debt but also of unfunded pension liabilities and similar 'off balance sheet' items of intergenerational significance. The problem with the present fiscal rules in EMU is indeed that they focus too much attention on the next year's budget, or the budget deficit in the next 3–5 years, at the expense of the development of public debt in the long term. It should be possible to achieve a better synthesis between concern for long-term sustainability and appropriate action within an acceptable time span. The point of a more systematic analysis of the sustainability of public finances, and of their intergenerational aspect, would be to give due weight to structural reforms, which are often far more important for public finance sustainability than actions to reduce the deficit in the short term.

6.6 The case for policy assignment

Analysis based on optimisation demonstrates that there may be a case in principle for policy coordination. As seen above, however, there is a much simpler alternative which, under reasonable assumptions, makes it possible to achieve largely the same benefits. This is the natural division of tasks, according to which monetary policy should aim at area-wide stabilisation while fiscal policy may be used to alleviate the effects of country-specific shocks. Also, fiscal policy needs to be complemented (or substituted for) by cost and price adjustment if the shocks are permanent rather than temporary. While shocks do not arrive with a label on them, the assignment principle is nevertheless a useful guide for macroeconomic responses to demand shocks. (For the supply side, a corresponding division of tasks is that the Union is entrusted with creating a framework for integration and competition while governments need to tackle bottlenecks and market impediments in the national context.) Assignment allows coordination to take the form of common rules (notably the SGP), exchange of information and dialogue, as well as methods of surveillance and peer pressure rather than discretionary policy coordination. This is helpful because there are many reasons for stressing the huge difficulties which any attempt at discretionary policy coordination or 'multilateral fine tuning' would involve.

First, policy coordination requires information that is highly uncertain or simply not available. The predictability of economic developments is poor and available knowledge of the structure of the economy is quite limited. Decision-makers may not even know the sign of policy effects, particularly as far as the cross-border effects are concerned. Discretionary policy coordination would, under these circumstances, run a serious risk of aggravating macroeconomic instability rather than reducing it. Assume, for instance, that decision-makers would agree that a change in the fiscal–monetary policy mix is desirable in order to strengthen the euro. What should they do: loosen fiscal policy and raise interest rates (the MF conclusion) or the reverse? The answer depends not only on the structure of the economy but also on hard-to-evaluate repercussions of policy on expectations and confidence.

Second, negotiation costs for genuinely discretionary policy coordination at the level of the Monetary Union would be formidable, involving interactions between, *inter alia*, the ECB and governments as well as national parliaments. It would necessitate a difficult political and bureaucratic exercise, with long time lags in decision-making and risks for the quality of the information set being used. Practical considerations suggest that policy arrangements need to be simple and robust if they are to be manageable with reasonable efficiency.[17]

Third, there are obvious risks for political failure due to short-term and electoral considerations receiving too much weight in governmental planning and decision-making. As explained by the literature in the public choice tradition, this could be reflected in an inflation bias, deficit bias, procyclical fiscal policies and a tendency to excessive debt accumulation.

It is for reasons such as these that national experiences of fine tuning have mostly been discouraging and that the experience of multilateral fine tuning, if attempted, would most likely be even worse. This is why the treaty is based on a clear assignment of roles and responsibilities between the various actors and respect for commonly agreed rules as a basis for decentralised decision-making (while not foreseeing discretionary coordination). Policy-making based on assignment makes it possible to avoid centralisation or coordination which would otherwise be indispensable but also extremely difficult to manage. The 'Maastricht assignment' reflects the concern that (explicit or *ex ante*) coordination would harm the transparency, accountability and credibility of the policy regime by blurring responsibilities and by putting the independence of the ECB at risk.

Reliance on a rules-based system rather than discretionary coordination is not enough for those who believe that EMU needs to be associated with an 'economic government' forming a political counterpart to the ECB. However, EMU has so far not triggered any significant deepening of political integration in the EU. A single currency without a unitary state to back it up may be historically unique (as has often been pointed out), but so is the EU. A big push towards something more akin to a political union, if it is to happen, will need to come from some other direction.

Annex: policy coordination in EMU

Section 6.1

The model used in section 6.1 for deriving the comparative statics set out in Table 6.1 is essentially as follows:

$$(6.A1)\qquad Y_i = E_i[(1-t_i)Y_i, R] + G_i + T_i(Y_i, Y_j, C/P_i, P_j/P_i) + X_i$$

$$(6.A2)\qquad \dot{C} = z(S-C)$$

$$(6.A3)\qquad R = R_f + \pi_S + \rho,$$

$$\text{where } \rho = \rho(G_1 - t_1Y_1, G_2 - t_2Y_2), \rho_i > 0$$

$$(6.A4)\qquad R = k_P\dot{P} + k_S(S-C) + k_M[PL(Y,R) - M],$$

$$\text{where } Y = Y_1 + Y_2,\ P = w_1P_1 + w_2P_2$$

(6.*A*5) $\pi_S = \dot{S},$

(6.*A*6) $\dot{P}_i = \pi_i + v_i(Y_i - \overline{Y}_i) + u_i$

where Equation (6.A1) is the equilibrium condition for the goods markets (being indexed for countries 1 and 2) and where the other equations are as set out in section 5.2. The reaction function of the central bank, Equation (6.A4), plays an important role; it is sufficiently general to cover not only a response to exchange rate changes but also to the cases of inflation and money stock targeting. Inflation expectations are assumed to be given in the short run.

While general solutions for the model are rather complex, analysis in section 6.1 is concerned only with the short-term equilibrium prevailing for given price levels. Also, analysis is restricted to the three special cases discussed in the text. It turns out that the solutions for the three cases are quite simple. In presenting them, it will be convenient to simplify notation by defining:

$s_i = \partial E_i/\partial(1-t_i)Y_i,\ \ m_i = \partial T_i/\partial Y_i,\ m_{ij} = \partial T_i/\partial Y_j,\ \ e_i = \partial T_i/\partial(C/P_i),$
$a_i = \partial T_i/\ \partial(C/P_j).$

In the case of a *stable currency* ($k_S \to \infty$), $R=R_f+\rho$, and Equation (6.A1) may, for given price levels, then be solved for dY_i to give:

(6.*A*7) $$dY_i = [dG_i + dX_i) + \theta_j(dG_j + dX_j) + (E_{iR} + \theta_j E_{jR})d\rho]/ (s_i + m_i - \theta_j m_{ji})$$

where $\theta_j = m_{ij}/(s_j+m_j)$. This is the pure Keynesian 'multiplier model' with the addition that the effects of fiscal policy may be reduced or mitigated by its effects on ρ.

For the case of a *stable money stock* ($k_M \to \infty$), $M/P = L(Y,R)$ will hold and this, in combination with Equation (6.A1) gives the corresponding expression for dY_i as:

(6.*A*8) $$dY_i = (1/\Delta)\{[1 + (E_{jR}L_Y / L_R(s_j + m_j))](dG_i + dX_i) - [(E_{iR}L_Y - m_{ij}L_R)/L_R(s_j + m_j)](dG_j + dX_j)\},$$
$$\Delta = s_i + m_i + \theta_j m_{ji} + [L_Y/(L_R(s_j + m_j)][E_{jR}(s_i + m_i + m_{ij}) + E_{iR}(s_j + m_j + m_{ji})]$$

Finally, the case of a *stable price level* ($k_P \to \infty$) with the constraint $\dot{P} = 0$, in combination with Equation (6.A1), implies that:

$$(6.A9) \qquad \begin{aligned} dY_i &= (1/\Delta)\{dG_j + dX_i - \varepsilon(dG_j + dX_j) + (e_i - e_j\varepsilon)dC + \\ &\quad (e_i + a_i - a_j e)dP_i + [(e_j + a_j)e + a_i]dp_j \\ &\quad - (1/w_j v_j)[m_{ij} + (S_j + m_j)\varepsilon]dQ\} \\ \Delta &= s_1 + m_1 + m_{21} + (w_1 v_1 / w_2 v_2)[m_{12} + (s_2 + (s_2 + m_2)\varepsilon] \\ Q &= \sum w_i(\pi_i + u_i) - \pi^* \end{aligned}$$

where π^* denotes the target rate of inflation (assumed to be zero). Assuming $\varepsilon = E_{1R} / E_{2R} = e_1 / e_2$ implies that Y_i is independent of C and that the reduced form coefficients of P_1 and P_2 are the same (with opposite signs); that is, that only the price ratio P_1 / P_2 matters for Y_i. A change in monetary policy towards expansion would in this model amount to a rise in π^* (but would have no effect if it were immediately reflected in a corresponding rise in π_i). The expressions above justify the assumed signs in the reduced forms (6.A10) and (6.A11) below.

Section 6.3

It is assumed that the monetary policy of the central bank is fully non-accommodating, the central bank keeping the overall price level stable by standing ready to adjust the interest rate as required ($k_P \to \infty$). Assume, for convenience, also that the countries are symmetric to the extent that $E_{1R}/e_1 = E_{2R}/e_2$ (which implies that the relative price P_1/P_2 is unaffected by C). The change in the relative price and the level of output of the home country may then be expressed as:

$$(6.A10) \qquad \begin{aligned} &\dot{P}_1 - \dot{P}_2 = v_1(Y_1 - \overline{Y}_1) - v_2(Y_2 - \overline{Y}_2) + \pi_1 + u_1 - \pi_2 - u_2 = \\ &f(\underset{+}{G_1 + X_1}, \underset{-}{G_2 + X_2}, \underset{-}{P_1 - P_2}, \underset{+}{\overline{Y}_1}, \underset{-}{\overline{Y}_2}, \underset{+}{\pi_1 + u_1}, \underset{-}{\pi_2 + u_2}) \end{aligned}$$

$$(6.A11) \qquad \begin{aligned} Y_1 &= \overline{Y}_1 - (w_2 v_2 / w_1 v_1)(Y_2 - \overline{Y}_2) - (1/v_1)[(\pi_1 + u_1) - \\ &\quad (w_2 / w_1)(\pi_2 + u_2)] \\ &= \phi_1(\underset{+}{G_1 + X_1}, \underset{-}{G_2 + X_2}, \underset{-}{P_1 - P_2}, \underset{+}{\overline{Y}_1}, \underset{+}{\overline{Y}_2}, \underset{-}{\pi_1 + u_1}, \underset{-}{\pi_2 + u_2}) \end{aligned}$$

These expressions are the basis for the graphical analysis and the comments in section 6.3 above. In particular, Equation (6.A11) defines the slope of the *PP* curve, while Equation (6.A10) defines the movement along the curve as a function of exogenous and predetermined variables.

Section 6.5

Assume that the government minimises a loss function in terms of deviations from targets for output (determined by Equation (6.9)) and the state of public finances, represented by both the cyclically adjusted budget balance B_S and the level of public debt D:

$$C = (1/2)[(Y - Y^*)^2 + \alpha B_S{}^2] + \beta B_S D \quad (6.A12)$$

where $B_S = G - t\bar{Y} + RD$ is the cyclically adjusted budget deficit and where β is the weight of the debt variable (or the product of the debt and deficit variable) in the loss function. Setting fiscal policy (G) so as to minimise the loss function implies the following fiscal policy reaction function:

$$G - t\bar{Y} = (\phi_G/\alpha)(Y^* - Y) - [R + (\beta/\alpha)]D \quad (6.A13)$$

where ϕ_G refers to the reduced form coefficient of G on Y. Fiscal policy thus reacts to output and public finances as assumed in Equation (6.11) in section 6.5.

It is obvious that the interest burden on public debt, RD, is an increasing function in the stock of debt. Also, the second derivative is positive if rising debts add to the risk premium ($\rho' > 0$), as is assumed to be the case in Figure 6.6 for high debt levels. Linearising Equations (6.8)–(6.11) and the fiscal policy reaction function above, allows the primary budget surplus to be expressed as:

$$t\bar{Y} - G = (1/\Delta)[\phi_R(t + \phi_G/\alpha)R + (1 - t\phi_G)(R + (\beta/\alpha)D], \quad \Delta = 1 + \phi_G{}^2/\alpha \quad (6.A14)$$

Stability of the model requires that $\partial(t\bar{Y} - G)/\partial D > \partial(RD)/\partial D$, or that:

$$[\phi_R(t + \phi_G/\alpha) + \phi_G(\phi_G/\alpha - t)]\rho' - \phi_G(t + \phi_G/\alpha)R + (1 - t\phi_G)(\beta/\alpha) > 0 \quad (6.A15)$$

This is likely to hold for low debt levels, as there is then no risk premium ($\rho' = 0$), and it certainly holds if β (the weight of public debt in the loss function) is great enough. It is also easy to verify that the second derivative of the primary surplus with respect to the stock of debt is negative (implying the curvature assumed in Figure 6.6) if the weight given to the budget deficit is sufficiently small in the government loss function (as it may be, at least at low debt levels).

7
Structural Policies

The domain of structural or microeconomic policies, occasionally also referred to as supply-side or long-term policies, is vast and much more difficult to characterise than macroeconomic policies. Structural policies typically affect particular sectors or are otherwise selective in their impact. They aim at strengthening the supply side of the economy and at improving its capacity to adjust to changing circumstances. The final objective is to raise the long-term growth potential of the economy and thereby its capacity to deliver high living standards as well as social and environmental protection.

The role of the EU in the area of structural policies[1] varies from the insignificant to the dominant depending on the case. The general rule is that Community competence is strong for issues important for the functioning of the internal market, while the role of the Community is weak where cross-border effects are thought to be of little significance. As will be seen below, this is reflected in the fact that Community legislation and action play a much bigger role in the internal market for goods (section 1) and financial services and institutions (section 2) than in labour markets (section 3). It should be emphasised that the structural issues are often associated with institutional circumstances and country-specific traditions of great complexity. This chapter accordingly will not aim at any systematic analysis but will identify only some main issues of principle.

7.1 The internal market

The Rome treaty (1957) laid the basis for the common market. The aim was to achieve a transformation of segmented national markets into a single common market, and this endeavour has remained a centrepiece of economic integration in Europe ever since. The process was given impetus by the Single European Act (SEA) of 1986, which set the Community the task of completing the creation of a single market by 1992. More importantly, it generalised the use of QMV in that area (nowadays more often referred to as the internal market), thus creating preconditions for a more effective decision process. QMV has since then been one of the pillars of the EU strategy towards the internal market, though tax matters and much of social regulation remain subject to unanimity. This section will briefly outline the benefits of the internal market and the regulatory strategy of the EU in this area.

7.1.1 Benefits of the internal market

The motivation behind the drive towards the internal market, towards making the economies of all member states function effectively as a single economic unit, is both political and economic. The political idea is that economic integration should create and clarify common interests, thereby strengthening the bonds and the readiness for political cooperation between member states. The economic consideration is that economic integration should enhance beneficial competition. Economic integration may be defined as the reduction or elimination of barriers to the mobility of goods, services, production factors, financial transactions and communication flows. Such integration should strengthen competition and thereby lead to lower prices, better quality offered and wider choice. This consideration is in the free-trade tradition, stressing the role of specialisation for productivity and growth, acknowledging Adam Smith's dictum that 'the division of labour is limited by the extent of the market'.

A very simple illustration of the idea of the internal market is set out in Figure 7.1, which shows demand D and supply S for a particular good in country A (left panel) and country B (right panel). Assume first that autarchy prevails, because of prohibitive tariffs or other protectionist policies, and that demand and supply will accordingly have to be equal in each country separately. Assuming competitive conditions on both markets, this implies the equilibria represented by points A and B and associated with the price P_A in country A and price P_B in country B respectively (as well as corresponding quantities of supply and demand).

Assume next that all trade barriers between the two countries are eliminated and that the two markets therefore effectively become one market. The market-clearing price is now P_U, and at this price country A imports the amount CD which equals the amount of exports EF of

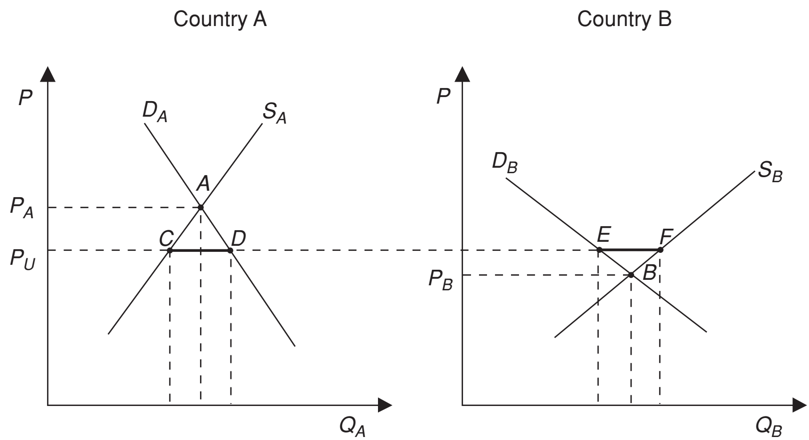

Figure 7.1 Market integration

country *B*. As a consequence of integration, supply or output in country *B* increases, as does demand or consumption in country *A*, while consumption in country *B* and output in country *A* decrease.

The welfare effects of integration are usually evaluated on the basis of the consumers' and producers' surpluses. The former is measured by the area below the demand curve (above the prevailing price level), while the latter is the area above the supply curve (below the price). Inspection of Figure 7.1 reveals that consumers in country *A* gain more than producers lose, the difference being the triangle *ACD*, while in country *B* the producers gain more than consumers lose, the difference being equal to the area of the triangle *EBF*. Economic integration in this case benefits both countries and the union as a whole.

This analysis, while extremely simple, arguably captures some essential aspects of market liberalisation and integration. In particular, it demonstrates that integration has the potential to be beneficial to all participants. This is of fundamental importance and should make it easier to achieve agreement on liberalisation. However, the analysis also shows that there will be both winners and losers. In principle, it should be possible for the former to compensate the latter so that everybody is better off, but in practice such compensation may not be feasible or may not take place. It is therefore understandable that those standing to lose will resist liberalisation and integration while those standing to gain will take a more favourable attitude. Vocal reactions may be expected, particularly from the side of producers (as they are better organised than the consumers and have more concentrated interests).

There are a number of important complications, neglected in the simple analysis, which need to be considered in order to get a more detailed picture of the issues and problems involved in the workings of a well-functioning internal market.

Trade diversion. The belief in the benefits of free trade has been widely shared by economists for centuries (ever since the case was vigorously made by classical economists such as David Ricardo and Adam Smith). It is also natural to think that the elimination of trade obstacles between some countries may be seen as a step towards (global) free trade, and that it should thus make a positive contribution to efficiency and welfare. However, such a view takes too much for granted. Free trade within the EU is also associated with a common external tariff. As demonstrated first by Viner (1950), the formation of a customs union involves both trade creation and trade diversion effects. The former arises when tariff reductions allow high-cost domestic production to be replaced by low-cost production from a partner country in the union. The latter refer to the possibility of discrimination against third countries, which may imply that low-cost production from countries outside the union is crowded out or replaced by more costly production from within the union. In terms of the two-country situation considered above, the original situation could have been one where country *A* was covering part of its total demand by imports from a low-cost country *C*. Forming a union between countries *A* and *B* and setting a common external tariff according to the average of the tariffs of member states (as was the case in the EU) might lead to imports by country *A* from low-cost producers in country *C* being replaced by more expensive production from country *B*. There is no certainty that the formation of a customs union is beneficial globally, though there is a presumption that the participating countries benefit from eliminating trade barriers among themselves.[2]

Quotas and non-tariff barriers. There are many other trade barriers in addition to tariffs. One of the most important is the natural barrier caused by transport costs, which are a function of physical distance but also of transport infrastructures and transport policies. The internal market can be exploited to the full only if Europe-wide infrastructures are of high quality, and the Community has for a long time sought to enhance integration by investment in trans-European networks and by trying to formulate a common transport policy (with mixed results). Quotas are also an important trade barrier, which have at times been widely used to regulate trade with third countries for sensitive products such as agricultural commodities. Further barriers to trade are created by the administrative and other costs related to differences between countries in technical standards and regulations as well as differences in tax rates and procedures. The effects of these barriers are similar to those of tariffs; action to remove or reduce them within a union may be associated with both trade creation and trade diversion (and positive global welfare effects cannot always be taken for granted).

Competition, firm size and product variation. The discussion has so far assumed perfect competition to prevail both before and after integration. In reality, some of the most important consequences of reductions of trade barriers are the effects on competitive conditions in markets.

Only three simple observations will be made on this complex topic. First, integration will be associated with an increased number of firms that are competing with each other. This should reduce margins and monopoly rents to the benefit of consumers. Second, larger markets may make it possible to exploit economies of scale which otherwise are not attainable. This should enhance efficiency in production and allow lower prices. Third, larger markets may support a larger product variety to the benefit of consumers. These effects, which are emphasised in the so-called new theory of trade, may well be more significant than the trade creation and trade diversion effects traditionally focused upon.

7.1.2 The regulatory strategy and enforcement

Setting up the internal market cannot be done by voluntary cooperation because individual member states have incentives for free riding and for respecting Community rules selectively, if at all. By the early 1980s, it was obvious that the Community had failed to achieve a true internal market for goods and services; in fact, the Commission at the time underlined that member states were becoming more protectionist and that non-tariff barriers tended to increase. Yet, there was also an increasingly wide realisation that a well-functioning internal market is a common interest of great importance to all member states. This paved the way for political agreement in the Commission and the Council on the need for a strategy towards the internal market which is strong, backed up by supranational powers, and which gives due weight to both regulatory activity and effective surveillance of implementation (the 1992 single-market strategy). The basis for such a strategy was laid in the SEA in 1986, which introduced QMV for (most) internal market matters. Until then, progress was frequently prevented by the insistence of member states on the introduction of excessive detail into internal market regulations. Removing the veto obstacle made it possible to avoid these deadlocks. Other elements of the internal market strategy that have emerged, as the result of a long process of learning by doing, include notably the following:

First, the strategy is geared to the 'four freedoms' (free movement of goods, services, capital and labour). Member states should dismantle any measures or arrangements which make intra-EU imports more difficult or costly than sales of domestic producers (the principle of non-discrimination), and there should be no artificial obstacles to the cross-border provision of services or to the establishment of firms in other member states than the home country of the entrepreneur. In particular, the treaty prohibits not only quantitative restrictions but also all measures having an 'equivalent effect'. Any product legally made and sold in one member state should be admitted to the markets of other member states, unless barriers can be justified by serious concerns about, for instance, public health or other aspects of consumer protection. A related key element of the strategy is the principle of 'mutual recognition' (introduced after the famous Cassis de Dijon ruling of the Court of Justice in 1979). This principle implies that member states cannot insist on the application of national regulatory specifications (in food laws, machine safety regulations, and so on) for imports from other member states, provided that the national regulatory objectives of the member states concerned are 'equivalent'. Mutual recognition thereby makes heavy inroads into the regulatory autonomy of member states.

The third element of the strategy is reliance on minimum approximation or harmonisation in cases where equivalence of regulatory objectives does not exist or is open to doubt. Such regulatory action should take the form of directives setting out the essential requirements and objectives but without being too prescriptive with regard to the means. In other words, it should respect the principles of subsidiarity and proportionality. When called for, the details of setting standards could preferably be left to special European standardisation bodies (in the spirit of delegation). These elements, taken together, form the essence of the 'new approach' to the regulation of the internal market (built on the SEA).

Community regulation may not be effective unless backed up by action ensuring enforcement and appropriate trade policies. It is therefore important that the Commission is granted sufficient powers to ensure that Community regulation is properly implemented. Three elements of the enforcement system will be referred to in this context.

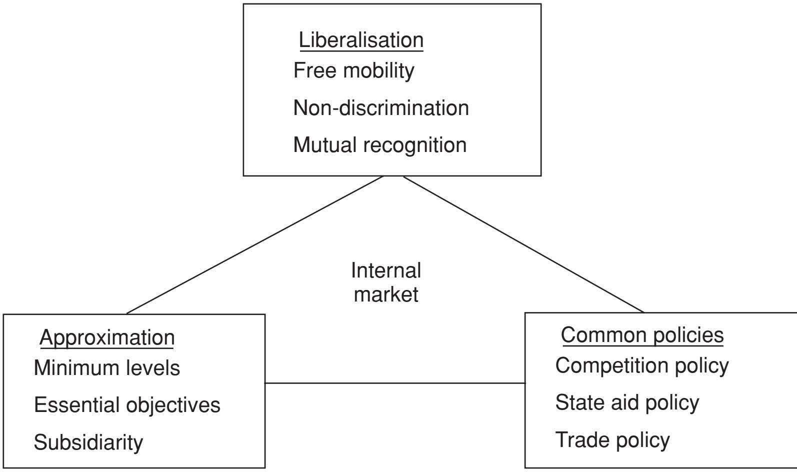

Figure 7.2 The regulatory framework of the internal market

Competition policy. The treaty gives clear expression to the commitment of the Community to the guiding principle of an open market economy with free competition. More importantly, the treaty also gives the Commission the power to prohibit actions deemed to distort competition and even to impose fines in cases of violation of Community rules. Action is directed notably towards preventing or abolishing cartels or restrictive arrangements between otherwise independent firms as well as towards ensuring that mergers do not give rise to anti-competitive dominant positions or monopolies. It is up to the Commission to take the formal decision to prohibit practices deemed unacceptable in the light of the relevant treaty articles (such decisions being subject to appeal to the ECJ), and the Commission may impose fines for violation of the competition rules. Indeed, it has consistently attacked horizontal cartels concerned with (for instance) price fixing, and heavy fines have been imposed in many cases. However, the Commission has in some cases also encouraged certain forms of cooperation between companies with a view to achieving efficiency gains through, for instance, joint research and development. Subsidiarity applies also in the area of competition policy in the sense that distortions of competition affecting only the domestic market remain a matter for national competition policy of the member state concerned.

State aids. It is obvious that state aids to companies may distort competition. It is accordingly not surprising that state aids favouring certain companies or specific sectors are incompatible with the internal market and therefore prohibited. As with cartels and dominant positions, the prohibition only applies with regard to state aid which may have a bearing on trade between member states (while issues of only local interest are left for national authorities). Also, state aids may be accepted if justified by social or regional concerns. If the Commission finds that an aid is not compatible with the treaty, it can decide that the aid be terminated or modified. (However, such a decision by the Commission can be overruled by the Council acting in unanimity.) If the member state does not comply, the Commission can take the offender to the Court of Justice for a final verdict and for a decision on fines.

Public procurement. Discrimination in national and regional public procurement is forbidden, as it is incompatible with free competition in the internal market, but discriminatory practices have been difficult to eliminate. The Community has introduced a series of strict procedural rules with a view to tackling this problem and promoting competitive procurement. These procedures concern, *inter alia*, publicity (should be timely and detailed), special obligations for tenders restricted to preselected bidders, and monitoring by the Commission.

There is no doubt that the internal market has made enormous progress during the past two decades, and that it stands out as a main contribution of the EU. Nevertheless, work is still needed (and ongoing) with a view to improving its functioning in many areas, particularly in the area of services.

7.2 Financial services and markets

Integration in the EU has progressed more slowly in services than in goods. A main reason for this is that approximation and mutual recognition are hard to achieve in areas with extensive, complex and idiosyncratic regulatory and supervisory regimes (in addition to linguistic barriers and differences in local conditions). Financial integration is proceeding in the form of direct cross-border sales of financial services, the setting up of subsidiaries and branches, and through mergers and acquisitions. Mutual interdependence and the significance of cross-border spillovers are now increasing rapidly. Yet member states are very reluctant to relinquish national control in favour of a stronger role for the Community (thereby illustrating the deep-rooted ambivalence in attitudes to European integration). The tensions and risks associated with the present institutional framework suggest a clear need for better coordination and/or centralisation of regulation and supervision of the financial system. This section will make some remarks on financial services in general and on the role of Community action in this area, which is of particular importance from the point of view of economic policy.

7.2.1 The functions of the financial system

One may conceive of three functions or 'tasks' performed by the financial system, this term referring to financial instruments as well as markets and institutions in a broad sense. A first function is to provide a means of exchange and a payments mechanism. The availability of an efficient payments system has the character of a public good and is an important precondition for the market economy. A second role is to channel resources from economic agents (firms, households and public authorities) with a financial surplus – with disposable income exceeding spending on consumption and real investment – to agents with financial deficits. The transfer of resources can be effected through borrowing funds directly by selling securities to lenders in financial markets, or it can take place indirectly via the activities of financial institutions such as banks. By fulfilling this role, the financial system is instrumental for an efficient allocation of resources as well as for capital formation and growth.[3] It also allows households to shift consumption over time through borrowing or financial investments. Third, financial instruments and institutions facilitate risk management by pooling risks (insurance) and by diversifying and reallocating risks from more to less risk-averse agents.

The functioning of the financial system has in some respects the character of a public good, is associated with substantial positive externalities and problems of asymmetric information, and gives rise to significant economies of scale and scope. There is therefore ample justification for government intervention to prevent negative effects of market failure. Given the size of actual and (even more so) potential cross-border effects, there is also a need for Community action with a view to ensuring that financial integration promotes efficiency and stability in the Union as a whole.

The means of payment for cash transactions is (nowadays) everywhere a public good provided by public authorities, notably by central banks. As far as the euro area is concerned, the promotion of the smooth operation of payment systems is one of the tasks of the ESCB, and the ECB has the exclusive right to authorise the issue of banknotes within the euro area. The ECB has set up a specific infrastructure to support the payments system, the Trans-European Automated Real-time Gross Settlement Express Transfer system, more often referred to as TARGET. This system interconnects national gross settlement systems operated by NCBs and thereby facilitates the smooth functioning of settlements of cross-border payments. The Community has legislated on cross-border payments in euros with a view to giving incentives to banks (or, more broadly, the payments industry) to create effective EU-wide payment infrastructures.

Financial integration in Europe has the potential to contribute to a well-functioning financial system with deep and liquid markets offering a wide choice of instruments and of venues for transforming saving into investment and for management of risks. Increased competition should result in a lower cost of capital for borrowers and a higher rate of return for investors, also fostering a more efficient allocation of resources. Exploitation of economies of scale and scope may help reduce the cost of financial services. Improved possibilities for risk diversification might, if supported by appropriate supervisory arrangements, enhance stability and resilience against adverse shocks of the financial system and the economy as a whole.

As in other areas of the internal market, an EU strategy of minimum harmonisation and mutual recognition may be instrumental in making markets more effective. However, there are certain reasons for regulation of financial markets and services which merit particular attention.

The case for *banking regulation* is based on the systemic risks associated with their core activity, the transformation of short-term deposits into long-term loans. This maturity transformation makes banks vulnerable to liquidity problems in case of large-scale withdrawals of deposits. Problems in one bank could spill over to other banks (risk of contagion) and lead to a generalised run on banks. To minimise systemic risks to stability, central banks stand ready to provide liquidity to the banking system, banks are required to have deposit insurance systems, and banks are also subject to regulations such as minimum capital requirements. Financial integration obviously raises coordination issues as bank failures could have significant cross-border effects. The emergence of transnational financial institutions calls for clarity with regard to the allocation of responsibility for their supervision and of cost-sharing in the case of emergency support. Risks for negative externalities and systemic failures (like bank runs) imply a need for Community legislation as well as for coordination or centralisation of supervision of financial institutions. It is also important that the

ECB, or the ECB in collaboration with NCBs, stands ready to provide liquidity to banks facing problems.

The rationale for the *regulation of non-bank financial institutions* is different, and is related more to concerns about imperfect information on the part of investors. It is difficult and costly, notably for small investors, to obtain the information needed to establish the quality of firms offering financial services. The consequence may be poor selection by investors, who cannot discriminate between high- and low-quality providers of services, and therefore insufficient incentives for firms to invest in high quality. Such problems of asymmetric information (buyers being less well-informed than sellers) may obviously lead to adverse selection and moral hazard. Regulation may be of help by setting minimum standards and defining requirements and rules that service providers must respect.

As financial services are generally subject to extensive regulation, the main issue in financial integration is not liberalisation as such but rather how to achieve a more efficient regulatory system at the EU level. As argued in an influential evaluation of these issues,[4] the problem with the EU's regulatory framework is that it is 'too slow, too rigid, complex and ill-adapted to the pace of global financial market change'. Europe-wide regulation is lacking for a large number of issues, and this prevents the implementation of the mutual recognition principle. In areas where directives have been adopted at the Community level, national implementation is often inconsistent and suffers from lack of agreement on how rules should be interpreted. Problems are caused by differences in legal and accounting systems, different approaches to corporate governance and differences in capital taxation. Funded pension schemes are not well developed in some countries, and pension funds are often part of public or semi-public pension systems with objectives and operating rules set by the authorities. The existence of a large number of clearing and settlement systems fragments liquidity and increases costs, notably for cross-border activity. This list of deficiencies of EU financial markets and services could easily be made substantially longer.

7.2.2 Financial regulation and integration in the EU

EU integration in the area of financial services was for a long time lagging behind, as compared with the goods markets, though some directives on banking and non-life insurance were adopted as early as the 1970s. An important step was taken by the endorsement by the European Council in 1985 of the Commission White Paper on completing the internal market by 1992, which set out a number of measures aimed at furthering the integration of financial markets through mutual recognition and home country control. Another important step was the endorsement of the Delors report on EMU in 1989, which called for the removal of almost all barriers to trade in financial services and for the right to cross-border establishment of financial insitutions. Yet fifteen years later, financial markets continue to be fragmented, not only by cultural and linguistic barriers, but also by national rules and regulations which often reflect long-standing practices and traditions. A high degree of integration has been achieved mainly in the wholesale money market and the market for bonds, while national segmentation continues to characterise equity markets and most retail activities. The combination of extensive regulation and great national diversity gives rise to problems which are difficult to tackle. (As stated in a committee meeting in the EU by Professor Alberto Giovannini: 'Europe has a history – and that's nobody's fault!')

Most countries have set up comprehensive systems of regulation of both banks and non-bank financial institutions though there are differences between countries and periods. In particular, regulation has traditionally been more onerous on the continent as compared to the UK, which gives more weight to self-regulation by the sectors concerned. The latter arguably has the advantage of flexibility as compared to formulation and enforcement of statutory regulation, but it is open to the criticism that it does not provide adequate consumer or investor protection. Over time, regulation was steadily increasing everywhere in the postwar period up to the 1980s. Since then, the trend has been partly reversed owing to the increasing pressure caused by advances in information technology, financial innovation and economic integration.

Efforts to establish an internal market for financial services in the EU are based on the acceptance of mutual recognition and minimum harmonisation. The latter should be restricted to 'essential requirements' such as supervisory or prudential standards and procedures. Minimum standards should pave the way for applying mutual recognition based on home country control. A set of directives has been adopted which stipulates that cross-border activities of banks are mainly supervised in their home country, though this may be supplemented by information-sharing within an informal network among national supervisors. Common rules apply to minimum capital requirements, concentration of risks, deposit insurance, rules of conduct and assignment of supervisory responsibilities. The principle of the single banking licence implies that a bank authorised to pursue activities in its home country needs no further authorisation to conduct similar operations in other member states. Another achievement is a directive on non-life insurance, which makes a distinction between large risks and mass risks involving small policy-holders. Supervision of the former takes place in the home country (mutual recognition), while supervision of the latter is mainly regulated in the country where the risk is situated (host country control). The distinction reflects the view that small policy-holders need special regulatory protection which must remain the responsibility of the country of residence of the policy-holders.

Action to speed up financial integration by a more efficient regulatory process has benefited from the application of QMV in the SEA. It has been high up on the agenda, particularly since 1998 when the Commission started to define priorities and deadlines in the Financial Services Action Plan. This plan outlined more than forty proposals to be adopted by 2005, covering a wide range of financial services and aiming to tackle the shortcomings and the lack of European regulation of essential financial services and markets. With QMV it has been possible to adopt a number of legal acts in spite of the often pronounced differences in attitudes of member states.[5] Legislation has recently been adopted in areas covering, for instance, requirements for disclosure of financial information by listed companies, insider dealing (market abuse), prospectuses of issues, investment services and activities of exchanges, occupational pension funds and mutual funds. Further legislation is under way in areas such as the capital framework and risk management of banks and investment firms (negotiated in the framework of the Bank for International Settlements and often referred to as 'Basel II'), solvency requirements in insurance and supervision of reinsurance. The EU is presently making substantial progress towards creating a comprehensive legal framework for an internal financial market based on free movement and mutual recognition as well as common regulatory objectives and principles.

In parallel, the Community has tried to speed up the regulatory process by adopting a new method, the so-called 'Lamfalussy procedure' (set out by a committee of wise men chaired by Lamfalussy). This was originally proposed for the securities markets but will be applied also to banking and insurance. It aims at speeding up the co-decision procedure and at raising the quality of national transposition while making it more consistent across countries. It does so by making a difference between core or framework principles, to be established by the Parliament and the Council within the co-decision procedure, and implementing rules, to be decided by the Commission. Also, the approach calls for early and broad consultation of market participants, close collaboration between national supervisory authorities, and action by the Commission to ensure a more effective enforcement of Community rules.

7.2.3 Financial stability and supervision

Integration and efficiency are as important in the financial services area as in other parts of the internal market. But as noted above, financial markets and, notably, banking activities are associated with one important problem, which goes far beyond the internal market: the systemic risks for financial stability. It may also be argued that monetary and financial integration increases these risks and that greater efficiency therefore may come at a high price. The history of financial institutions and markets gives ample evidence of the large costs that may arise in the wake of financial turbulence and notably as a consequence of banking crises.

Public authorities try to contain the financial stability risks by means of regulation of risk-taking of banks and other financial institutions in combination with supervision of the activities of these institutions. Other means of promoting stability include deposit insurance and the provision of emergency liquidity by central banks (the so-called lender-of-last-resort function). In cases of solvency problems of financial institutions, public authorities may end up using taxpayers' money (sometimes very significant amounts).

The allocation of responsibilities with regard to financial stability is presently far from clear-cut within the EU or the euro area. First, the organisation of supervision differs between countries. Sometimes it is a function of the central bank, in other cases it is the responsibility of an autonomous agency, often with close links to the ministry of finance. Also, supervision may be centralised or organised sectorally to deal separately with, for instance, banking and insurance. Second, the organisation of supervision comes into a new light as integration proceeds and as cross-sectoral and cross-border links in financial activities become stronger. Yet the ECB or the Eurosystem is not competent in this area; the treaty asks the Eurosystem only to 'contribute to the smooth conduct of policies pursued by the competent authorities relating to prudential supervision of credit institutions and the stability of the financial system'. Also, it is not clear how the lender-of-last-resort function will be handled in a case of a serious liquidity shortage (though it may be presumed that it would be addressed jointly and in close collaboration by the ECB and the NCBs concerned).

Existing arrangements may be deemed vulnerable and may turn out to be insufficient if or when the euro area is hit by a combination of banking exuberance and a serious macroeconomic shock triggering loss of confidence and a banking crisis. Coordination between different supervisory authorities within and between EU member states has been established, but there are no firm rules or pre-established chains of command for the handling of emergency situations. The present lack of clarity is perhaps an expression of 'constructive ambiguity' (which usefully reduces the risk of moral hazard), but it runs the risk that national supervisory authorities will not react sufficiently swiftly and decisively in a crisis situation. It has therefore been argued (see, for instance, Bini Smaghi and Gros, 2000) that it is time to contemplate more fundamental reform and to set up a European Financial Supervisory Authority (EFSA). The EFSA would have the task of improving coordination between national supervisory agencies and would gradually become responsible for implementing supervision for the most important pan-European banking institutions. However, there is no political readiness to give the Community level competence for financial supervision. Instead, present efforts focus on improving the coordination and notably the exchange of information between all relevant bodies, including both the national supervisors and NCBs as well as EU level committees and the ECB.

7.3 Labour markets and social policy

It is widely thought that potential growth in Europe is too low and the unemployment rate persistently too high because of structural problems hampering the functioning of markets. A prime target for this line of criticism is labour markets, which are seen as lacking flexibility because of tight regulations and excessively generous social protection systems. Successive versions of the Broad Economic Policy Guidelines (BEPGs) have articulated the need for economic reform to reduce regulatory and tax burdens on companies and workers as well as to 'modernise' social protection systems and 'make work pay'. But equally, European Council conclusions almost invariably call for a strengthening of 'Social Europe' (alternatively of the social dimension, the European Social Agenda, or the European Social Model). There is much ambiguity with regard to the ambitions in the social area and notably about the proper role of action at the EU level. This section will first discuss the social consequences of economic integration and then make some comments on labour market regulation and social policy coordination in the EU.

7.3.1 Social consequences of economic integration

As argued above (section 7.1), economic integration has the potential to increase overall welfare. However, the integration process has wide ramifications, some of which are problematic and give rise to concerns. In particular, it is often felt that integration erodes national sovereignty and autonomy of social policy of member states (the former understood as legal authority and the latter as *de facto* capacity to act so as to achieve objectives). As pointed out by Vandenbroucke (2003), the rules of the internal market (free movement of labour and of services) have created obligations, the scope of which deviates from national borders. For instance, member states can no longer limit social benefits to only their own citizens. Also, member states have to accept that their benefits may apply to citizens residing outside their national territory. Furthermore, governments cannot in all cases exclude foreign entities from providing social benefits (such as health care) to their citizens. While such spillovers from the internal market to social policies raise interesting issues of principle, which have been highlighted in recent rulings of the ECJ, these are (so far) not significant enough to have major consequences for the framework or role of social policies of member states.

Of greater importance are the indirect effects of intensified market competition and their consequences for various groups in society and for the trade-off between policy objectives. In particular, integration might hurt specific interests and groups. Consider, for instance, the enlargement of the EU to include ten new member states from central and eastern Europe, which took place in 2004. This will enhance integration and have significant consequences for trade flows and production within Europe. The new member states will increase exports of goods based on their relative abundance of cheap labour and thereby displace some labour-intensive production in old member states (particularly of goods with a low skill intensity). This will improve the employment and wage prospects for labour in the new member states. It will generally benefit consumers by intensifying competition and putting downward pressure on prices. However, stiffer competition may lead to job losses and downward pressure on wages of (low-skilled) workers in the old member states. Such job losses may be magnified by foreign direct investment shifting production from old to new member states. Furthermore, migration of labour from new to old member states may increase competition in the latter for available jobs also in sectors normally sheltered from competition. Economists may (rightly) insist on the virtues of free trade and economic integration, but many workers may rather see the threat of job losses and lower wages.

These problems of integration, and not least the associated perception of risks and insecurity, will most likely have political repercussions in one form or another. First, there may be pressure to protect domestic production, to prevent firms from laying off workers (or delocalising production), or to reduce immigration. However, the rules of the internal market do not give much scope for action along these lines. Second, there will be increased demand for labour market regulation, more social protection and active labour market policies. This is not without problems as social benefits may delay necessary adjustments, because social protection is already absorbing a large share of public budgets, and as integration may intensify tax competition making it more difficult to finance a high level of public expenditure. Third, given these difficulties it may be argued that there is a need for a Europe-wide social policy to help manage the social consequences and to safeguard the political acceptability of the integration process.

7.3.2 Social regulation and social policy coordination in the EU

It is often taken for granted that social policy is detrimental to economic efficiency. This need not be the case, because labour market regulation and social protection may be called for to counteract market failures. For instance, credit markets may not permit unemployed workers to borrow with a view to sustaining consumption. A mandatory public insurance scheme may help reduce the poverty risk associated with unemployment by allowing risks to be spread across the population. A public intervention is necessary because optional insurance would lead to adverse selection (only high-risk employees would seek insurance and premia would accordingly be high). Similar arguments can be advanced for public health insurance and pension systems. Health and safety regulation may be called for because individual workers cannot be well-enough informed about risks in a complex working environment.

As argued in Chapter 2, it is not enough that there be a rationale for government intervention; it should also have a clear cross-border dimension (spillovers) to justify action at the Community level. This requirement is not always fulfilled for EU legislative proposals. For instance, it is not obvious why the EU should legislate on the use of temporary agency workers (as proposed by the Commission) or why there should be a Community directive on working time (as long as health and safety requirements are met). The cross-border effects are limited while national differences in circumstances are considerable.

Aside from market failures, social policy in the form of income support programmes and benefits may be called for to reduce poverty and achieve a politically more acceptable income distribution. There may also be a case for governments to subsidise the provision of merit goods, such as education and health care, if it is thought that individuals do not always act in their own best interest (being myopic even if not otherwise irrational). A counter-argument is that social regulation and policies, under the influence of rent-seeking pressure groups, may be unduly geared to distributional advantages with negative efficiency implications. Tight labour market regulations may protect the jobs and wages of those already having a safe job ('insiders') at the cost of the unemployed, those entering the labour force or workers in temporary jobs ('outsiders'). High unemployment and other social benefits (or benefits with a long duration) may add to wage rigidity, reduce job search and prolong unemployment spells (thus adding to long-term unemployment). Taxes and benefits often reduce the financial incentives to work and thereby contribute to inactivity and unemployment traps (therefore calling for action to 'make work pay').

Depending on circumstances, there may thus be a trade-off between social considerations (safety and equity) and requirements of economic efficiency. The choices of society with regard to that trade-off are of great importance and are (or should be) at the centre of political debate. But that is a debate which mainly takes place within member states rather than in the EU. And this is reasonable because there are no obvious cross-border externalities in the context of social protection that would justify policies on these issue to be brought to the Community level. The mainstream view is therefore that social concerns should remain a matter for national consideration and choice.

The main counter-argument to this view is based on the observation that the internal market intensifies competition not only between products and companies but also between regulatory systems and social policies. Member states may be tempted to introduce lax regulations or to cut social costs (or reduce taxes or grant state aids) with a view to attracting investment and firms from other jurisdictions. This amounts to 'social dumping' and may at worst lead to a 'race to the bottom'. Coordination at the EU level is therefore called for to restrict such regulatory or policy competition. Given the great differences in national circumstances and preferences, which make it difficult to achieve full harmonisation, the EU should realistically aim no further than adopting harmonised minimum requirements so as to set a floor to 'harmful competition'.

However, the conclusion is a different one if policy-makers are viewed not as benevolent social planners but as opportunists ready to seek short-term gain and to pursue sector-specific interests with a view to being re-elected. Intensified competition within the internal market may then be seen as a blessing which limits the scope for excessive regulation, and social protection programmes which are not in the general interest. Be that as it may, social dumping is arguably, in practice, less of a threat to the welfare state than its own high costs, including the mounting costs of pensions and health care of the elderly (owing mainly to the demographic trends).

The treaties indeed reflect the view that social policy is an area best left mainly to member states, and social legislation was, until the mid-1980s, decided by unanimity. This did not prevent legal acts from being adopted in certain areas. The internal market for labour with free mobility and non-discrimination is rendered difficult by the fact that migrant workers will have to deal with two different social protection systems: one in their country of origin and one in the country of residence. Community legislation on social policy coordination has therefore been enacted with a view to enhancing compatibility between the social protection systems of member states and to ensuring, for example, pension portability for migrant workers while avoiding 'benefit shopping' or 'social tourism'. Similarly, there is a need to clarify the social policy treatment of cross-border workers. Also, the EU has actively sought to enhance the principle of equal pay between men and women. Furthermore, the Community has exercised its competence to regulate in the area of health and safety at work. Such legislation was facilitated by the SEA and the Maastricht treaty which introduced QMV for certain social areas (e.g. minimum requirements for health and safety at work, working conditions, informing and consulting workers, equality between men and women in the labour market). Other developments of some relevance for EU social policy include the Social Charter, the European Social Fund and the tripartite social dialogue.[6]

While social policy and social regulation remain, in spite of the legislative and other activities referred to above, a matter largely for national consideration, the debate at the EU level has recently received renewed impetus as part of the Lisbon process (see section 4.4.3). Successive European Council meetings have encouraged policy coordination processes, under the umbrella of the 'open method of coordination' (OMC), based on information exchange, dialogue, benchmarking and identification of best practices, the setting of policy objectives and timetables for action, multilateral surveillance and peer pressure.

Proponents of Social Europe see the OMC as a substitute for Community regulation and hope that the 'soft' methods will in due time lead to more ambitious action at EU level. Others consider it to be a way of acknowledging the relevance of social concerns while keeping binding decisions on them outside the sphere of Community action. The motivation for the escalating coordination activity based on the OMC is thus somewhat ambiguous. Nevertheless, these processes have undeniably raised the political awareness in member states of the need and options for action in areas such as social inclusion, pension systems (see Box 7.1) and health care for the elderly. Also, coordination helps to articulate and spread the message that Europe needs concerted action with a view to 'economic reform' to make its economy more flexible and efficient and to achieve high sustainable growth rates and employment levels.

Box 7.1 The pension problem

Europe is facing a dramatic aging of its populations. This will have important consequences for society and for the welfare state. One implication is that the costs of pension systems (and of health care for the elderly) will increase substantially. In the absence of reform, member states would have to increase taxes by several percentage points of GDP to prevent unsustainable public debt developments. So far, few member states have undertaken comprehensive reform and there is concern about problems of unsustainability for roughly half of the old fifteen member states.

The forthcoming challenge of aging populations for the sustainability of public finances has been a recurrent theme in policy coordination work in the EU. It has been the subject of regular reports, multilateral surveillance and European Council conclusions. Member states agree that the appropriate response to the challenge is a three-pronged strategy: employment rates need to be raised, public debt levels should be reduced in anticipation of the later strains, and the pension systems themselves must be reformed.

Reform of pension systems may aim at reducing the benefit level, increasing contributions, raising the effective retirement age and improving the incentive effects. Parameters that may be the focus of reform include the actuarial correspondence between contributions and benefits, indexation rules, early retirement schemes and links from life expectancy to the benefit and/or contribution rates. Yet the financial sustainability of 'adequate' pensions is difficult to ensure unless the overall employment ratio can be raised in the EU. Also, there is an urgent need to improve public finances and reduce debt levels in the medium term.

While too little has been done to implement the three-pronged strategy and while the consequences of aging populations remain very much a matter of concern, there is no doubt that work on this issue (in the context of stability and convergence programmes and the BEPGs as well as within the OMC), and the attention given to it in European Council conclusions, have served a useful purpose. The pension problem is now high on the political agenda in all member states, and there is more public awareness of the need for reform. Also, the information produced and the dialogue on reform options has helped relevant ministers to initiate and enhance reform projects in their own member states.

It is sometimes implied in these discussions that it is the Anglo-Saxon model which should be emulated more generally. Reality, however, supports no simple generalisations. For instance, the Nordic countries are often deemed to be socially successful and economically competitive in spite of (or even helped by) big public sectors and high tax rates. There are, even in Europe, several variations of the welfare state, with important differences between the southern countries, the 'Anglo-Saxon' countries (the UK and Ireland), the 'Bismarckian countries' (Germany, Austria, France and Benelux) and Scandinavia (including Finland). All the models have their advantages and disadvantages, and their appreciation depends on national traditions and preferences. This suggests that 'Social Europe' should remain a set of general principles, and that the EU should continue to respect national diversity and the primary responsibility of national governments for the social welfare of their citizens.

8
Tax Policy

Should the EU aim at coordination, approximation or harmonisation of taxes and, if so, why and how? These questions are controversial and the results achieved in EU work on tax policies must be deemed very modest. This chapter first reviews the political difficulties related to tax policy in the EU context (section 1), and then examines the prevailing situation and recent developments in indirect taxation (section 2) as well as direct taxation (section 3).

8.1 Taxes and sovereignty

Commission proposals in the area of taxation tend to get a cautious or suspicious reception among member states, and tax issues often give rise to arduous work and heated debates in the Council. There are three fundamental reasons for this.

First, taxation goes to the heart of national sovereignty. The emergence of parliamentary democracy is closely linked to power over taxation (as reflected in the slogan of the American revolution 'no taxation without representation'), and decisions on taxes have in past centuries led to revolutions, wars of independence and subsequent changes of constitutions. There is arguably no issue more important to the nation state, symbolically and practically, than the question of who holds the power over taxes.

Second, taxation has historically been mainly a domestic issue (when considered separately from customs duties). The cross-border effects of tax policy decisions used to be small, either because economic integration was not very advanced, or because tax rates were low and/or the tax structure tilted towards relatively immobile tax bases (e.g. land taxes). Weak interdependence has allowed countries in Europe to develop idiosyncratic tax systems with country-specific particularities, and this historical heritage amounts to a difficult starting point for attempts at tax policy cooperation.

Third, views on tax policy are intrinsically linked to differing perceptions of the role of politics and democracy, or of state and government. As noted in Chapter 1, there are those who see government as a self-aggrandising monster inclined to ever higher taxes to finance an over-bloated bureaucracy and transfers to rent-seeking groups which successfully manipulate the democratic system to their advantage. Strong competition on the internal market is the best if not the only defence against this harmful political bias, and tax competition should therefore be welcomed and encouraged rather than hindered or managed. This view is predicated on the assumption that governments do not act with a view to compensating for 'market failures' but go far beyond that legitimate task and are vulnerable to 'government failures' (see Chapter 1).

Others believe that democratic decisions reflect genuine preferences of the electorate that should be respected. Tax competition, if strong enough, is from this perspective seen as harmful precisely because it undermines tax policy autonomy. Cooperation should be aimed at in the EU (and beyond) with a view to curbing excessive tax competition and to safeguard possibilities for using taxes as an instrument of policy while taking account of cross-border spillovers. This view is predicated on the assumption that politically unguided market competition cannot be successfully used as a mechanism for allocating resources whenever market failures are pervasive or the consequences for the income distribution intolerable.

Uncoordinated tax policies or strong tax competition may, in conditions of high interdependence, give rise to several problems. In particular, lack of coordination may:

- distort the functioning of the internal market if resources are channelled to projects which are lightly taxed rather than to projects with the highest pre-tax return
- put upward pressure on taxes on internationally relatively immobile factors, such as labour, to compensate for the loss of tax revenues from mobile tax bases, such as capital income
- aggravate unemployment (by raising the tax wedge on labour income) and
- make it difficult for the government to finance the welfare state and redistributions in favour of the poor.

As a matter of fact, labour taxes have risen in recent decades in most countries, while capital taxes have remained unchanged or declined. High capital mobility seems to have induced governments to shift more of the tax burden onto relatively immobile factors. The increased taxation of labour has probably contributed to the high level of structural unemployment in the EU, but has apparently not forced member states to reduce the size of the public sector.[1]

The political sensitivity of taxation has, in the EU, had one consequence of particular significance: all decisions in this area are subject to the unanimity requirement. As seen in Chapter 3, this gives rise to high negotiation costs, encourages strategic behaviour, and allows each party to the decisions to set preconditions for deliberations which constantly risk leading to deadlock. While tax questions are often legally and administratively complex, it is the political difficulties which are the main explanation for the poor track record of the EU in this area (notably in the area of direct taxation).

8.2 Indirect taxes

The creation of a genuinely borderless internal market is one of the fundamental objectives of the EU. While transport costs, as well as linguistic and cultural differences, will continue to imply some market segmentation, there should be no regulatory, administrative or tax obstacles to purchases and sales within the EU. The treaty defines the objective for Community action in the area of indirect taxation as 'harmonisation of legislation concerning turnover taxes, excise duties and other forms of indirect taxation to the extent that such harmonisation is necessary to ensure the establishment and the functioning of the internal market'. The question is how the system of indirect taxes should be designed and whether the requirements of the internal market allow tax autonomy of member states.

The Community decided in 1967 to adopt a value added tax (VAT) system. The VAT system levies tax at the value added at each stage in the process of production and trade until the good or service reaches the final consumer. (Technically this is done by levying VAT on the gross value of the product while allowing VAT on inputs to be deducted.) It is generally considered that this system is superior to alternative indirect tax systems, which give rise to a cascade of taxes (being levied at the gross value at each stage of production) and therefore give artificial incentives to vertical integration of firms and problems of border tax adjustments. Some harmonisation of the VAT system may be considered desirable also in the light of its role for the financing of the Community budget (see Chapter 9). The structural harmonisation of indirect taxation remains the main achievement of the EU in the tax area.

The VAT system in the EU is mainly based on the *destination principle*, which specifies that commodities going to the same destination shall bear the same tax irrespective of their origin. VAT is levied on final sales to the domestic consumer, irrespective of whether the good is produced domestically or imported, and no tax is levied on exports. The destination principle may be clarified with the help of Figure 8.1.

It is assumed in Figure 8.1 that the VAT rate in country *A* is *x per cent* and that the rate in country *B* is *y per cent*. Domestic sales are subject to these VAT rates, while exports are zero-rated and sales of importers subject to the VAT rate in the country of destination. This should ensure that the VAT rate is the same for domestic goods and imports in both countries (though the VAT rate may be different between countries), and thus there would be no distortion of competition. While the elimination of border controls within the EU poses problems for the implementation of the destination principle, the present regime operates a system of exchange of information which should make it possible for VAT rates to be properly levied,[2] but the system is costly and vulnerable to fraud.

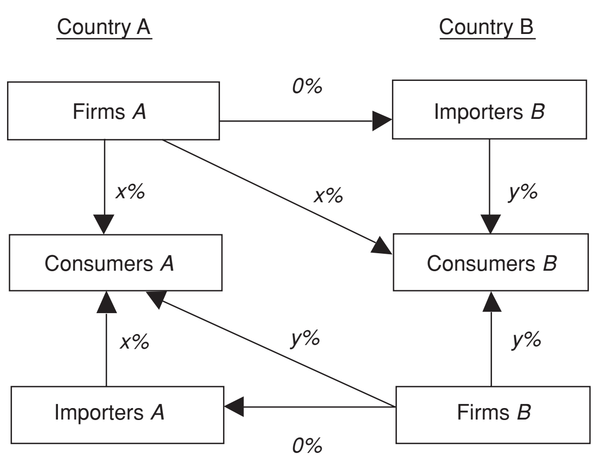

Figure 8.1 The destination principle (VAT rates)

Another problem arises when consumers purchase goods directly from firms in other countries (cf. the arrows from firms in country *A* directly to consumers in country *B* and vice versa). Cross-border shopping will be subject to the tax rate of the country of origin rather than the tax rate of the country in which the consumer is resident (country of destination). The problem inevitably becomes quite important for 'footloose' activities, and special solutions have therefore been designed for cars and electronic commerce (with the destination principle being applied for distance selling when the value of the transaction exceeds a threshold). Cross-border shopping is presently of considerable significance in border regions between countries with large differences in VAT rates (such as Germany and Denmark), particularly for products where excise duties add to the difference in relative prices (such as cigarettes and alcoholic beverages).

The Commission has repeatedly proposed that the EU should move to a 'definitive system' based on the *origin principle*, which specifies that commodities with the same origin shall bear the same tax irrespective of their destination. The origin principle, if adopted, would imply that products from country *A* are subject to a VAT rate of *x per cent* irrespective of whether consumed domestically or exported (zero-rating for exports would be abolished). Such a definitive system would have the attraction of simplicity and it would reduce the risks of fraud. However, it would lead to distortions of competition between member states as relative prices would be affected not only by production costs but also by relative VAT rates. The system based on the origin principle can function well only if differences between the VAT rates in member states are relatively small, much smaller than is presently the case. Also, a system based on the origin principle would for political reasons need to be accompanied by a redistribution mechanism to ensure that the VAT revenues go to the member states in which the actual consumption takes place.

The rules on VAT rates presently in force in the Community, introduced through a directive in 1992, are far from simple. They are based on a definition of minimum rates: 15 per cent for the standard rate and 5 per cent for reduced rates. Member states may apply one or two reduced rates to goods and services listed in an annex to the directive. However, there is also a large number of country-specific exceptions and derogations, including items for which zero VAT rates have been accepted (in negotiations on directives or in accession treaties). Some of the derogations have an expiry date, others are quasi-permanent or without any fixed date of expiration. Also, in 1999 the Council decided on an experimental application of reduced VAT rates to certain labour-intensive services for two years, and this experiment has since been prolonged twice. In addition to the differences in standard and specific VAT rates comes the fact that excise duties for certain products continue to differ significantly between member states.

The Commission takes the view that the system of indirect tax rates is much too complicated and should be simplified, essentially through harmonisation. The Commission also points out that studies have failed to demonstrate that reduced rates would be reflected in lower consumer prices or more jobs. Many member states, by contrast, insist that their reduced VAT rates serve important social or political objectives and argue, on the grounds of subsidiarity, that they should have the right to retain and even expand the use of reduced rates. In practice, it seems that many of the items with reduced rates are of quite limited macroeconomic significance and do not significantly distort the functioning of the internal market. For instance, all politicians in the UK seem to consider the zero VAT rate on children's clothes and shoes to be of fundamental social importance, while the Netherlands wants to apply a reduced VAT rate for bicycle repairs and barber shops!

On balance, there seems to be little reason to prevent member states from using reduced rates for specific purposes on internal market grounds (given the destination principle). While the cross-border shopping aspect pleads in favour of some approximation of rates, this is the case mainly for easily transportable goods, much less so for a number of services. In light of the differences in social and political priorities of member states, one may indeed consider it a great advantage of the destination principle that it does not require tax harmonisation but is compatible with subsidiarity or national sovereignty in the setting of rates.

One negative aspect of the present legal situation in the area of indirect taxation concerns the focus of discussions. It would seem natural that Community discussions should focus on the choice of basic principles and on those goods where tax differences may have direct and significant cross-border effects. In practice, however, much time and effort is spent on discussions of details of indirect taxation which are of little significance for the internal market. One may argue that indirect taxation suffers from excessive Community regulation: given that indirect taxation is Community competence, member states cannot change specific VAT rates without a proposal of the Commission and a unanimous decision in the Council. Yet, given the unanimity requirment, such discussions tend to become very difficult and bogged down in mutually inconsistent demands by individual member states. It is therefore very difficult to make any modifications to the system even when changing circumstances so require.

It is obvious that member states are not politically willing to harmonise their VAT rates, and the preconditions for the origin system are therefore not met. However, the Commission has not yet given up the hope that the EU could move from the present 'transitional' system based on the principle of destination to a 'definitive' system based on the principle of origin. Work on the indirect tax system is therefore hampered not only by the unanimity requirement but also by differing perceptions and aspirations with regard to the basic principles and objectives of the system. At some stage the Commission and member states will have to agree that the destination principle will not be abolished in favour of the origin principle and that the setting of VAT rates may and should largely be left to member states, though some approximation for certain goods is needed to contain cross-border shopping.

While the role of legislative harmonisation should be limited, one may still argue that member states should aim at some coordination of their policies. There are indeed strong grounds for believing that manipulation of the structure of VAT rates is an impractical and inefficient instrument for creating jobs or for subsidising particular goods or services. It makes sense for member states to aim at an indirect tax system with a broad base and with uniform tax rates. However, this need not call for Community legislation but might better take the form of recommendations under the BEPGs or agreed codes of conduct for tax policies.

Also, there are cross-border externalities, such as the environmental consequences of the use of energy products. In such cases there is a well-recognised justification for using taxes to give incentives to economic agents with a view to energy-saving methods or to encourage innovations and environmental protection. Cross-border externalities offer a specific rationale for tax policy cooperation and even legislative harmonisation. Given the unanimity requirement, however, not much progress has been made in the EU with regard to green taxes or energy taxation.[3]

8.3 Direct taxes

EU discussions on direct taxes have focused almost exclusively on capital income taxation, defined as the sum of corporate and personal taxes on capital income. The discussion was given strong impetus by the decision in the late 1980s that capital flows should be fully liberalised as one of the steps towards EMU. One of the concerns raised by capital liberalisation was that it risks being associated with distortions of the internal market and political problems in member states if there is no coordination of tax policies. This section will review the distortions caused by differences between member states in capital income taxes as well as some of the key issues on which Community work is being focused.

8.3.1 Economic integration and capital taxation

The basic points may be clarified by a simple (textbook) analysis of the effects of capital taxation. The analysis is based on Figure 8.2, which assumes a two-country Union with a total capital stock of fixed size. The stock of capital in country *A* is measured on the horizontal axis from left to right and the amount of capital in country *B* from right to left. The marginal productivity of capital or the rate of profit in countries *A* and *B* are indicated by the curves R_A and R_B respectively, which are declining functions of the stock of capital. It is assumed that, initially there is no capital taxation. Furthermore, it is also assumed that, initially there is no capital mobility between the two countries and that the allocation of capital is given by K_0 (the stock of capital in country *A* being AK_0 while the stock in country *B* is BK_0). With perfect competition, the rate of interest equals the rate of profit in both countries, and this rate is higher in country *A* than in country *B* (being equal to the distance *AE* in country *A* as compared to *BH* in country *B*). It may be noted that the area inside CDK_0A is the total income generated by the capital stock AK_0 in country *A* (the integral of the marginal productivity of capital). The return to capital is given by the area of AK_0DE, while other income (the wage bill) is given by the area of the triangle *CDE*.

Assume now that capital controls are eliminated and that capital (in the long run) is reallocated from country *B* to country *A* (because the return to capital prior to liberalisation is lower in country *B* as compared to country *A*). The new equilibrium capital allocation is given by point K_1 for which the return to capital is the same (*AG*) in both countries. It may be seen that liberalisation enhances efficiency by reallocating capital from low to high productivity activities (in the absence of tax distortions). The value of production generated by the total stock of capital (the combined areas under the marginal productivity curves) increases by the area of the triangle *DFJ*. A second observation is that labour income in country *A* will rise as a consequence of the addition to

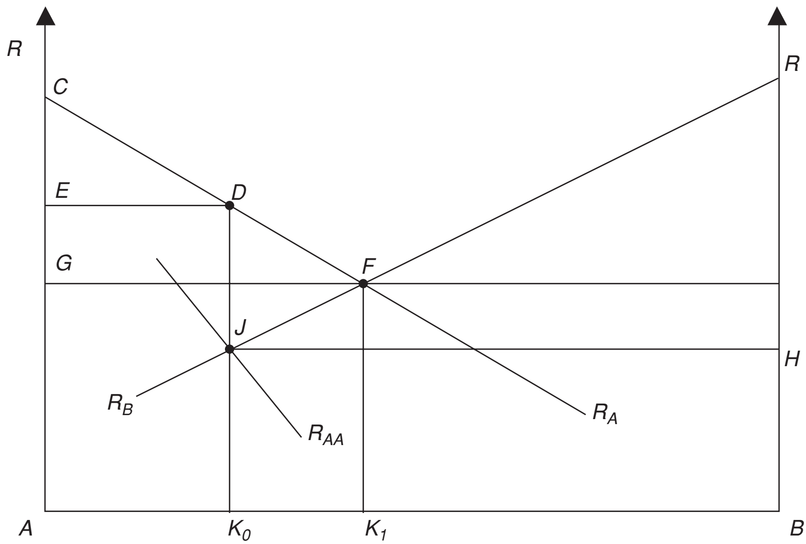

Figure 8.2 Capital taxation and integration

the capital stock (the size of the increase in total wages being given by the area of *EDFG*). Correspondingly, the decline in the capital stock will decrease labour income in country *B* (which could affect the political acceptability of liberalisation).

Consider now the effects of taxation of capital. In particular, assume that the authorities in country *A* were to introduce a tax on profits such that the net rate of return on capital (gross return less capital taxes) falls from R_A to R_{AA}. As a consequence, the equilibrium allocation of capital shifts from K_1 to K_0, and that allocation now reflects the effects of differential taxation rather than capital market segmentation.

This change would obviously be harmful for country *A* in terms of capital and employment. Furthermore, it would worsen the area-wide allocation of capital and reduce its total gross (before-tax) return. It does so because the tax in country *A*, in the absence of capital taxation in country *B*, distorts the overall allocation of capital (in favour of country *B*). Capital mobility will not equalise the pre-tax rate of return but will tilt the allocation of capital in favour of the country with low or no capital taxation. By the same token, capital market integration may actually worsen the allocation of capital if this reflects differences in tax rates rather than in marginal productivities.

It is (conversely) easy to see that a tax reduction will benefit the country undertaking it in terms of capital and employment; country *A* may, by eliminating capital taxation, obviously increase its capital from K_0 to K_1. A country reducing the tax rate may even increase its tax revenues from capital if the reallocation is big enough (if the supply of capital is highly elastic). But these effects will be to the detriment of the neighbouring country and possibly the Union as a whole (if tax distortions are thereby increased). The neighbour country could conceivably retaliate by reducing its capital taxation with a view to re-establishing the original equilibrium as far as capital allocation is concerned, though with the difference that both countries would have lost tax revenues and net rates of return on capital would be correspondingly higher.

Clearly it could make sense for the authorities in countries *A* and *B* to cooperate so as to contain tax competition. The supply of capital may be highly elastic from the point of view of an individual country, but is much less so for the Union as a whole. In Figure 8.2, it is in fact assumed that the aggregate elasticity of supply of capital is zero (fixed total capital stock), which would mean that the authorities by cooperating could tax capital without any loss of tax bases; capital mobility is obviously a key factor influencing the possibilities and desirability of taxing capital.

As already noted above, this analysis is extremely simple. For instance, it assumes a Union closed to the rest of the world, it makes no distinction between investment in new equipment and the stock of existing capital (and seems to assume that existing capital can be reallocated even though real investments are mostly irreversible), and it does not spell out the tax system (but assumes implicitly taxation of capital income at source as sole principle). Nevertheless, it brings out the valid points that capital mobility may tempt governments to 'steal' tax bases from each other by low tax rates (or other and more targeted incentives), and that such tax competition may result in resource misallocation and/or losses of tax revenue to the detriment of the common interests of the international community.

It is easy to see that capital mobility is (*ceteris paribus*) greater the smaller the economy. As the possibilities of attracting tax bases are good when their mobility is high, it is not surprising that tax competition tends to be exploited more by the small member states (e.g. Ireland and Luxembourg) rather than the large ones (e.g. France and Germany). In fact, provided that capital mobility is very strong, it might even make sense for some countries to abolish capital taxation altogether. To see this, assume that the country under consideration is an SOE (see Chapter 5) such that the interest rate is exogenously determined by the global interest rate (which corresponds to the case of infinite capital mobility). In Figure 8.3, capital is measured horizontally and the profit rate vertically, the world interest rate being *OW*. The marginal productivity/gross return on capital is given by the curve *RG*, and the net return by the curve *RN*. Assume that the SOE were to abolish capital taxation. What difference does it make?

Abolishing taxation does not affect the required net rate of return (given by world market conditions), which remains at *OW*, but raises the stock of capital from *OA* to *OB*. Total income increases; with taxation it is represented by the area *OADC*, in the equilibrium without taxation it is *OBFC*. Net capital income increases from *OAGW* to *OBFW*, while wage income increases from *EDC* to *WFC*.

Everything seems to indicate that the optimal capital tax in the SOE can only be zero. However, the tax revenue from capital income represented by the area *WGDE* is lost and needs to be compensated by increased taxation of wage income. This may reduce total production and income if higher taxes on labour income raise the gross wage rate and thereby the cost of production (shifting *RG* downwards). Only if labour supply is totally inelastic, implying that wages bear the full cost of higher wage taxes, will it remain the case that a zero tax on capital

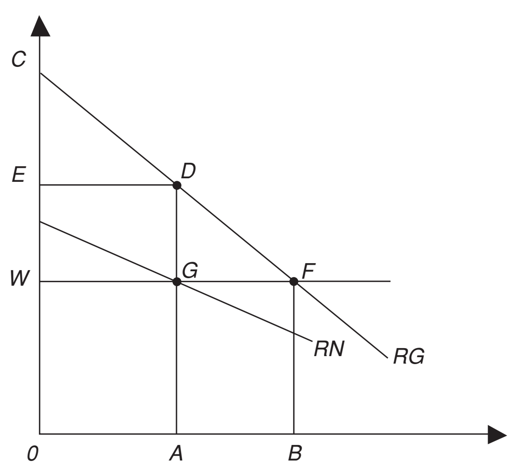

Figure 8.3 Capital taxation in the SOE

income is optimal from the point of view of efficiency. As seen above, a positive tax on capital income is desirable if there is international tax policy cooperation (or if capital mobility is limited).

While tax competition may be beneficial by helping to keep 'Leviathan' (public sector expansion) in check, the analysis above basically suggests that tax competition is a beggar-thy-neighbour policy and should be prevented through international cooperation. However, the issues arising out of tax differences and tax competition are complicated, not least if looked at in conjunction with (and as instruments of) regional policies (see Box 8.1).

Box 8.1 Capital taxation and agglomeration effects

While tax harmonisation has its merits, there is also a different perspective on capital or corporate taxation, which suggests that tax differences may have a useful role in helping to avoid excessive regional polarisation. This perspective is based on the assumption that there are large gains from co-location of firms and capital. Such agglomeration effects may give rise to positive 'external economies of scale' such that the marginal productivity of capital is, within some limits, an increasing rather than a decreasing function of the amount of capital in a given location (region or country).

This possibility is illustrated in Figure 8.4, where the (exogenously given) world interest rate faced by the SOE is again *OW* while the return on capital *R* first increases because of positive agglomeration effects before starting to decline (because of the usual declining returns to capital or because of negative 'congestion' effects). It is easy to see that there are now two possible equilibria, of which *U* is unstable and *S* is stable.

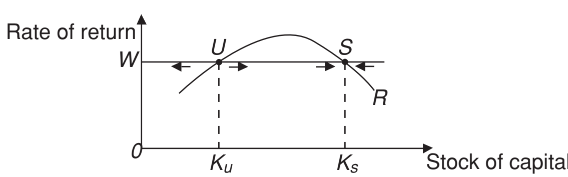

Figure 8.4 Capital taxation and increasing returns

Assume that the original capital stock were smaller than K_U (possibly as a consequence of a shift in technology increasing the importance of agglomeration effects). The return on capital would then be lower than that required by the market (*OW*), and this would have the remarkable consequence that the capital stock would be declining over time, ultimately towards zero! This self-reinforcing 'catastrophic' development could be avoided, however, if investment is encouraged by low taxes or subsidies until the capital stock is bigger than the critical minimum size of K_U.Then the rate of return would be high enough to initiate a self-sustaining process of accumulation until the capital stock K_S is attained.

There is no doubt that peripheral regions or countries have used low capital taxes or capital subsidies as a means of attracting foreign capital, sometimes with considerable success (e.g. Ireland). While the analysis above is much too simple to allow policy conclusions (there may notably be more effective means than taxes or subsidies for enhancing investment), it does suggest that the case against tax differences and tax competition may be less clear cut than is often thought, notably if agglomeration effects on integrated markets are significant and risk leading to regional polarisation. In particular, there may an 'infant industry' type of argument in favour of policies such as tax incentives. For an analysis of these and related issues, see Baldwin and Krugman (2000) and Braunerhjelm *et al*. (2000).

8.3.2 Taxation of cross-border interest income

Most member states try to uphold *the residence principle* of income taxation, according to which the taxpayer is liable to tax in his country of residence on his income from all sources, domestic and foreign. The attraction of the residence principle is that it ensures neutrality in the decisions of the investor, as he faces the same marginal tax rate on all investment alternatives. Arbitrage should then equate the pre-tax rates of return and thereby the cost of capital to firms. This should help to achieve efficiency in production. In principle, taxation based on residence also safeguards tax policy autonomy as citizens are taxed equally irrespective of the location of their assets. Investors can benefit from low foreign taxes only by moving abroad to become residents in low-tax countries, and such mobility is relatively limited (though it plays some role among the very wealthy).

An alternative regime is based on *the source principle*, meaning that income is taxed in the country in which it originates (the source country). Capital income is thus taxed in the country in which the investment is made, and no further tax is imposed in the country of residence. Differences in tax rates are likely to distort the international allocation of investment as arbitrage tends to equalise after-tax rather than pre-tax rates of return (cf. the analysis above in relation to Figure 8.2). Also, taxation according to the source principle opens up for tax competition as each country has an incentive to set tax rates low in order to attract investments. Tax revenues are to the benefit of the source rather than resident country. In practice, countries aspire to the residence principle but the reality of capital taxation is more in tune with the source principle.

The perspective of full liberalisation of capital movements in the late 1980s triggered a debate on the taxation of cross-border interest income, which has at times been lively, and is still going on. Interest income has been at the centre of the debate because of its quantitative importance, because of the high degree of substitutability between interest-bearing assets notably within the euro area, and as income in the form of dividends and capital gains is mostly subject to at least some tax at the corporate level. Authorities were and are concerned about the effects of tax arbitrage in conditions where residents are free to channel their financial portfolios to neighbouring countries, and even more by the fact that interest income accruing outside the country of residence may not be disclosed to its tax authorities. Citizens may choose not to honour the obligation to report foreign interest income as the risk of being caught is negligible. In fact, the tendency has been for each member state to become a tax haven for citizens of other member states.

Community discussions on the tax treatment of interest income have, since 1996, focused on the so-called 'tax package'.[4] The idea was originally presented by Commissioner Monti to the informal meeting of the Ecofin Council in Verona in 1996, and the Council agreed conclusions on a work programme on the tax package in December 1997. The package consists of three parts.

First, it was agreed that the Council should adopt a directive on the tax treatment of cross-border interest income of households within the EU. The suggestion at the time was that the Community should adopt the 'coexistence model', in which each member state could choose between applying a withholding tax on interest income or providing (automatically) information to the tax authorities of other member states (in order to allow taxation according to the residence principle). It was foreseen that member states applying a withholding tax would share the tax revenues arising with the member states of residence of those paying the tax. The coexistence model was a pragmatic attempt to resolve the problem of earlier discussions in which member states were split in their preferences between these two options, and above all it aimed at allowing banking secrecy to be maintained (notably in Luxembourg and Austria). Second, the Council agreed to work on a directive with a view to abolishing double taxation of interest and royalty payments between associated companies. Third, the Council agreed a legally non-binding code of conduct for business taxation (see section 8.3.3).

Work on the tax package, notably on the issue of taxation of cross-border interest, turned out to follow a somewhat dialectic pattern:

- In 1999 (in the meeting of the European Council in Helsinki), the Union failed to agree on the coexistence model because the UK was strongly opposed to the option of applying a withholding tax.
- Subsequent work focused on a model based solely on automatic exchange of information between tax authorities. In 2000 (in the meeting of the European Council in Feira), the Union agreed in principle that the directive should be based on exchange of information on as wide a basis as possible. The European Council also invited the Commission to pursue negotiations with certain third countries (notably the US and Switzerland) with a view to safeguarding EU tax arrangements from simply leading to capital flowing out.
- In June 2003, the tax package was finally adopted, but now it was again based on a *de facto* coexistence model. In particular, it was agreed that three member states (Austria, Belgium, and Luxembourg) and some third countries (notably Switzerland) could use the withholding tax option until developments in the OECD had advanced sufficiently in the direction of exchange of information. Also, it was decided that the withholding tax rate to be applied would increase over time from 15 per cent in the first years to 35 per cent after a transition period. However, there remain conditions (related to other negotiations with Switzerland) which need to be fulfilled before the directive on cross-border interest taxation will actually come into force.

It is too early to assess the significance of the directive on taxation of cross-border interest income; it is not yet clear whether it will come into force, and the effects of it are difficult to ascertain and open to doubt. Loopholes in the directive and financial innovations may allow markets to find ways of avoiding the tax. Also, financial markets may react by channelling funds from EU member states to third countries with which the EU has no agreement on relevant tax arrangements (such as Hong Kong or Singapore). Much will depend on the results of parallel work going on within the OECD with a view to abolishing banking secrecy and installing effective exchange of information between tax authorities. While the jury is still out as far as the final significance of the tax package is concerned, there are nevertheless at least two lessons that may be drawn from the work on it.

First, it amply demonstrates the enormous difficulties of reaching unanimity as required by the prevailing voting rules on tax matters. For progress to be possible it was necessary to hold literally hundreds of working party/committee meetings and for the Council and the European Council to spend hours and hours on the matter. It was also essential that work was carried out on the basis of a package with elements of interest to all member states. One may perhaps point to the tax package as demonstration that agreement is still possible even with unanimity, but this lesson is not the right one. Negotiations on the tax package were repeatedly blocked by requests of individual member states, sometimes requests which were totally unrelated to the package itself (see Box 3.1). Given enlargement, which accentuates considerably the heterogeneity of the EU, it is hard to believe that any significant further progress could be achieved in the area of capital taxation if no modification of the voting rule is introduced.

Second, it is increasingly obvious that issues of tax policy coordination will have to be dealt with not only in the EU but also at the international level, notably in the OECD. Taxation of interest income and income from financial capital more generally may not have a future unless banking secrecy is abolished. The tax package, even if implemented, will not meet its aspirations unless the international community is able to pressure all relevant financial centres to accept a framework for operating some system of exchange of information.

8.3.3 Corporate taxation

The current corporate tax regime in the EU is, in practice, close to a source-based system. Tax policy competition[5] is accordingly of considerable significance, implying that differences in tax rates between member states may distort the allocation of investment. Also, such differences give incentives to multinational companies to generate, or to appear to generate, their profits in the jurisdictions with the lowest rates so as to minimise their tax burden. Extensive discussions have taken place in the EU in the area of corporate taxation. During the 1960s and 1970s, the Commission made several proposals for harmonisation of corporate tax systems with a view to improving the functioning of the internal market. In the early 1990s, a high-level committee chaired by Onno Ruding proposed measures of partial tax harmonisation. However, little in terms of results has been achieved.[6] Recently there have been some attempts to resume work on corporate taxation; ongoing work in the EU includes certain elements of tax policy coordination as well as initiatives aimed at approximation or harmonisation of tax legislation within a two-track strategy defined by the Commission.

In particular, the tax package includes a commitment to coordination in the area of business taxation. In 1997, the Council agreed to fight 'harmful' tax competition in the form of targeted ('ring-fenced') tax incentives or schemes seeking to encourage location of business activity in a certain host country. Such schemes may be based on tax legislation or administrative procedures. The main point is that the tax incentives are not general but targeted with a view to 'stealing' tax bases from other countries. The Council also set up a high-level group (the code of conduct or 'Primarolo group', so named after the UK Paymaster General who has been chairing the group) to examine potentially harmful tax schemes of member states and to prepare decisions on standstill and roll-back of measures deemed to be harmful. The group put forward a list of sixty-six measures in 1999, and the Council agreed conclusions on the roll-back of these as part of the adoption of the tax package in June 2003. It should be noted that the code of conduct does not aim at harmonisation of business taxation; differences in corporate tax rates are not attacked as long as the tax rates are applied generally, without being targeted at particular firms or sectors.[7]

Beyond the tax package, the Council has endorsed a two-track strategy of the Commission: on the one hand, the EU should tackle certain tax-related inefficiencies and obstacles to cross-border economic activity in the internal market by targeted solutions that can be adopted quickly. On the other hand, the strategy foresees steps towards a longer-term goal of providing companies with a common consolidated tax base for their EU-wide activities.

The obstacles requiring immediate attention and targeted solutions include revisions to the merger and parent/subsidiary directives with a view to facilitating restructuring operations across borders and to avoid double taxation of dividend payments between all associated companies. Such amendments should also include the European Company Statute within the scope of these directives. Another issue of importance is how to avoid double taxation of corporate income because of the current limits to cross-border loss relief within the EU. Limited loss-offset is increasingly giving rise to court cases because it can be seen as discriminatory and as contradicting the 'four freedoms' (free movement of goods, services, capital and persons, including the right of establishment). Other urgent issues include recommendations to solve problems in the area of transfer pricing (to reduce costs of compliance with the Arbitration Convention), and the development of an EU model tax treaty or the conclusion of a multilateral tax treaty between all EU member states (to safeguard equal treatment).

The second track of the Commission's tax policy strategy is an ambitious attempt to pave the way for more comprehensive changes by means of discussion with a view to enhancing understanding and acceptability of radical reform. In 2002, the Commission published a Company Tax Study which identified four models for providing multinational companies with a single consolidated tax base for all of their EU-wide profits.[8] A consolidated tax base would eliminate the need for EU companies to deal with up to twenty-five different company tax systems within the EU, which makes operating across borders complex, notably for smaller enterprises, raising compliance costs. It would do away with the need for EU multinationals to identify 'correct' transfer prices for transactions between related entities, and it would automatically allow the offset of losses in one member state against profits in another. The Commission also suggested using formula apportionment for allocating profits to member states for taxation: the total EU-wide income of a multinational company would be allocated across member states by a fixed formula reflecting the distribution of the company's activity across countries.

More recently, the Commission has suggested giving priority to one of the options, the model of 'Home State Taxation' (HST) as a possible solution that could be offered at least or in the first instance to small and medium-sized enterprises (SMEs) as a pilot scheme and a test case. This option applies the logic of mutual recognition and foresees that the profits of a group of companies active in more than one member state should be calculated by using the tax system of the home state of the parent company or head office of the group. The company's EU-wide profits, thus calculated, would then be apportioned to the member states according to an agreed formula, and the profits allocated to each state would be taxed at that country's corporate tax rate. Such a solution should offer simplification and reduction of tax compliance costs for the companies that could use the option.

The problems raised by different corporate tax regimes within the internal market – distortions of allocation, compliance costs, erosion of tax bases through tax competition – become increasingly important as mobility increases. Birch Sörensen (2001) therefore suggests that harmonisation not only of the corporate tax base but also of the tax rate, in combination with formula apportionment, should be seen as an appropriate long-term goal of the EU. This need not imply any significant harmonisation of total taxation of capital income provided that the residence principle is upheld: member states could still control the total tax burden (corporate plus personal) on capital income through the rates applied for personal taxes on dividends and capital gains (if enforceable).

The strong insistence of several member states on the unanimity requirement in all tax decisions is understandable (see section 1) but also an anomaly. The point is not that the internal market would require harmonisation of tax bases or of tax rates; it does not, and is indeed compatible with leaving tax decisions to member states, provided that taxation is based on a combination of the destination and the residence principles.

In practice, however, member states are unable to exercise effective sovereignty unless their tax policy is backed up by international administrative cooperation. In particular, effective exchange of information is needed to enable member states to enforce residence-based taxation on income from portfolio investments. There is a clear need for strong international coordination in this area. Such a perspective must presently be deemed unrealistic, but developments in this direction could be encouraged if the tax package is implemented and if an effective system for exchange of information on cross-border interest income is created. The categorical refusal of some member states to accept any deviations from the unanimity requirement in the tax area (often even for measures aimed at better administrative cooperation) is not explicable in terms of their wish to retain control over tax rates and tax bases. Without effective international cooperation, national sovereignty is in reality doomed increasingly to become only an empty shell.

9 The Community Budget

The EU is a regulatory union, not a tax-and-spend union. One reflection of this is that the Community budget is very small in aggregate terms, amounting to no more than roughly 1 per cent of the area-wide GDP. Is the smallness of the budget an expression of a well-justified allocation of tasks between the member states and the Community, or is it an unfortunate consequence of political hesitation or lack of courage to accept the budgetary requirements of close economic integration? A comprehensive answer to this question is beyond the scope of the present chapter, which only attempts to shed some light on the issue by reviewing briefly the tasks of the EU in the light of principles developed within the theory of fiscal federalism (section 2). It also describes the financing of Community expenditure and the suggestion to endow the EU with a 'Community tax' (section 3). First, however, it briefly sets out the framework within which negotiations on the Community budget take place (section 1).

9.1 Negotiating the Community budget

The budget of the Community is financed by proceeds from its 'own resources', by taxes and other revenues that are formally considered as 'belonging' to the EU. In practice, however, the financing of the Union emanates from the member states, and the resources are generally perceived as their money. Thus, the European Parliament is a directly elected legislature with the somewhat peculiar prerogative of having 'representation without taxation'.

The resources of the EU are under strict control of the member states with multiple safeguards against any profligacy in Community expenditures. First, the Council agrees the 'Own Resources Decision' by unanimity and subject to national ratification. This decision defines the resources available for financing the Community (see section 3), and it thereby sets an absolute ceiling for Community expenditure. Second, the governments of member states agree, within the framework of an inter-institutional agreement of the Council with the European Parliament and the Commission, the financial framework or the Financial Perspective (FP) by consensus for periods of 5–7 years. The FP stipulates annual ceilings overall and for the various main categories of Community expenditure. The overall ceiling is below the ceiling for own resources (OR), leaving a margin for unforeseen expenditure, and the annual budgets must be compatible with the FP. While the key decisions are formally taken by Community institutions and notably by the Council, the unanimity requirement ensures that the negotiations have a strongly intergovernmental character.

The annual budget of the Community is decided by a special version of co-decision with the Parliament (set out in Article 272 of the treaty and in an interinstitutional agreement). As the own resources are decided separately, deliberations and decisions in the annual budget procedure pertain only to expenditure. The Council has the last word on 'compulsory expenditure', following mostly from treaty obligations, while the Parliament has the last word on 'non-compulsory expenditure', spending which is essentially at the discretion of the budgetary authorities. In this procedure, the Council decides by QMV and the European Parliament by differing majorities (in accordance with Article 272 of the treaty). Most of the Community budget is predetermined by legal commitments, and the Commission preliminary draft budget can therefore, in practice, be modified only marginally. It is nevertheless normal for the negotiations between the Council and the Parliament to include phases of confrontational posturing (with heated disputes about sums which rarely amount to more than a fraction of 1 per cent of the total budget). Failure of the two branches of the budgetary authority to reach agreement on the budget has the consequence that actual expenditure for various expenditure categories in each month is equal to 1/12 of the figure in the draft budget or of the actual expenditure during the previous year (whichever is smaller).

The Community budget is a well-defined framework and it has to comply with a number of budgetary principles that were mostly defined in the Treaty of Rome. These include the principles of:

- unity: all revenues and expenditure are to be included in a single budget

- annuality: expenditure is authorised for one year only[1]
- universality: no earmarking of revenues for specific purposes is allowed
- specification: all items of expenditure must have a specific objective and
- equilibrium: no financial deficit is allowed.

While power over the budget is shared between the two branches of the budgetary authority (the Council and the Parliament), it is the Commission that is responsible for its execution. The Court of Auditors annually furnishes a technical opinion on the financial management of the Commission as a basis for the discharge to be decided by the Parliament (on a recommendation of the Council).

Given the decision procedure and the constraints of the budget, the Community obviously can have neither a fiscal policy nor a tax policy of its own. In this setting, it is the size and the spending structure of the budget that attract the main interest. It is acknowledged that the benefits of the Community are primarily elsewhere than in the size of particular budgetary flows, but member states take great interest and attach considerable political importance to the difference between their payments into and their receipts from the Community budget. The 'net payers' want to keep the budget small (unless they can expect to benefit disproportionately from specific spending increases), while the 'net recipients' are typically more inclined to insist on the importance of cohesion and more generous Community spending. As the distribution of the financial burden of the Community budget as such is a zero-sum game, it can be agreed only as part of an overall package with many dimensions (that is, as part of a deal on the FP).

9.2 Community tasks and expenditure

The EU has some attributes of a federal regime. In particular, certain powers are conferred at EU level and the associated decisions are taken by Community institutions rather than by agreement between member states. However, the smallness of the Community budget obviously constrains the scope of the policies and programmes to which the EU may aspire.

While their shares have declined over time, Community expenditure is still dominated by two items of strongly redistributional character: spending on the Common Agricultural Policy (CAP) and on regional policy. The former accounts for almost half of the budget (46 per cent of Community expenditure in the budget for 2004), while the latter absorbs about one third (31 per cent of expenditure in 2004). Other headings of some importance include internal policies (covering items such as research and technological development as well as information, transport and energy networks), external policy and administration. The figures are set out in Table 9.1, which also recalls the fact that total payments appropriations in the budget for 2004 amount to less than 1 per cent of gross national income (GNI) in the EU, thus being clearly below the overall ceiling set in the FP and even further below the ceiling set by the own resources decision.

As argued below, there are no arguments of principle to justify the present composition of the Community budget. In particular, there is no strong case for the dominant position of the CAP and regional policy in Community spending. The tasks of the Community and the related expenditures may usefully be examined in the light of the theory of fiscal federalism and separately for the three functions of economic policy: allocation of resources, redistribution of income and macroeconomic stabilisation.

9.2.1 Allocation-related expenditure

The main economic tasks of the Community are to set up and to uphold the internal market. This requires the establishment and enforcement of rules with a view to achieving a level playing field

Table 9.1 Community expenditure, budget 2004 (EU 25, appropriations for payments)

	bn euro	*% share*
1. Agriculture	45.7	45.8
2. Structural actions	30.8	30.9
3. Internal policies	7.5	7.5
4. External action	5.0	5.0
5. Administration	6.0	6.1
6. Reserves	0.4	0.4
7. Pre-accession aid	2.9	2.9
8. Compensation (to new member states)	1.4	1.4
Total	99.7	100.0
relative to GNI	0.98 %	
FP-ceiling	1.10 %	
OR-ceiling	1.24 %	

for area-wide competition. It may also call for interventions in the functioning of markets to safeguard the supply of international public goods, to manage cross-border externalities and to exploit area-wide economies of scale (see Chapter 2). Such market failures cannot be dealt with by regulation only and may justify common policies and centralised action that need to be backed by Community funding. There are indeed a number of public goods that could, for good reasons, be provided at the EU level. Important examples include external defence and foreign policy, internal security, immigration policy and border controls as well as R&D and network infrastructures.

External defence and foreign policy (or aspects of them) are associated with large cross-border spillovers and scale effects.[2] The member states of the EU could therefore achieve much more in terms of military capacity and international influence at much lower cost by pooling their resources. The political difficulties of supranational action in these areas, traditionally close to the heart of national sovereignty, are obvious but need not be insurmountable. While different national traditions and preferences may call for a cautious and gradualist approach, it may also be noted that Eurobarometer surveys typically indicate considerable support among European populations for deeper integration in external defence and foreign policy.

The areas of internal security as well as immigration policy and border controls are also natural candidates for a stronger Community role. The absence of internal borders within the Community calls for integrated efforts at the Community level against crime (including terrorism) and illegal immigration, and the action needed goes beyond agreements on principles and rules. These do not provide sufficient safeguards against free riding; member states may not act with the required vigilance. Why should member state *A* take the trouble to control its borders effectively if illegal immigrants can easily enter its territory via *B* (or if illegal immigrants are likely only to pass through *A* to *B*)? Also, these are areas where policies have to be implemented through specific actions that give expression to discretionary decisions. The executive powers in these areas need to be (at least partly) brought to the Community level, and the powers may have to be vested with specific Community agencies in order to achieve effective implementation of policies and decisions. These examples are important but far from exhaustive; for instance, investments in basic research, R&D and network infrastructures are also associated with (cross-border) externalities that could justify significant action at EU level.

By contrast, the heavy subsidisation of agriculture in the EU (as in most of the OECD area) has no obvious economic rationale in terms of externalities, public goods or scale effects, being instead mainly due to the traditionally strong political influence of agricultural and rural interests. Taking into account also national transfers, OECD (2003b) estimates that total agricultural support[3] in the EU is €112 bn or 1.3 per cent of GDP (substantially more than the size of the EU budget as a whole). Some action may be called for to ensure food supply under all circumstances, and the preservation of traditional landscapes is a legitimate objective in itself. However, these considerations could be pursued by other means and do not justify anything approaching the present CAP.

There is widespread agreement among economists on the need for reform of the CAP, or for accelerating and completing the ongoing reform process. This aims at eliminating support schemes linked to prices and production quantities in favour of direct income support to farmers. Once the CAP has been reformed, there is no need for the redistribution in favour of farmers to be financed through the Community budget. As pointed out by Sapir *et al*. (2004), this redistribution policy might usefully be renationalised so as to allow member states to choose the level of ambition and the details of such redistribution policies (while respecting the rules of the internal market).

9.2.2 Redistribution in the EU

The theory of fiscal federalism calls for centralisation of redistribution policies if tax bases are highly mobile, because otherwise the policies at local level risk being undermined by difficult trade-offs (making the desired redistribution hard or impossible to achieve). There are, however, several reasons why this recommendation is of rather limited relevance in the EU context.

First, some tax bases are not very mobile internationally. In particular, cultural and linguistic barriers considerably limit the mobility of the labour force, and even significant differences in tax and wage levels are obviously feasible in Europe. Second, other tax bases may be highly mobile, not only within the EU, but more widely. This may be the case notably for financial capital and also for parts of corporate activity. Centralisation to EU level will not then in itself be enough to deal with the spillovers or to restore effectiveness of policies. Third, preferences for income redistribution may differ between member states. Also, redistribution policies stand better chances of succeeding in their aims without undermining economic efficiency if based on good information about local conditions, especially where there may be different models of welfare and redistribution that are successful, depending on country-specific traditions and circumstances. Centralisation might therefore be harmful by not giving sufficient weight to the heterogeneity of preferences and circumstances.

As noted above, the Community budget is strongly tilted towards spending with redistributive elements. The CAP obviously redistributes income in favour of agricultural producers, and it has traditionally benefited particularly large-scale producers. Regional spending, the other heavy expenditure item, aims at redistribution from relatively rich to poor regions as well as accelerating the economic convergence of poor regions to higher income levels. It is based on indicators of industrial structure, a peripheral geographic position or other regional characteristics. Member states are required to top up Community financing with domestic co-financing so as to reduce the risk of a crowding out of the latter by the former ('additionality'). This policy is felt to be important for maintaining cohesion and in view of the risk that competition on the internal market benefits the strong at the expense of the weak.

Box 9.1 Cohesion policy

Economic integration offers lagging regions good prospects of catching up provided that certain framework conditions are met (concerning, *inter alia*, the quality of public administration, infrastructure and education systems). However, there is also a tendency to regional concentration and specialisation because of 'agglomeration effects' and locally increasing returns to scale. Such phenomena might give rise to 'polarisation' of developments between a wealthy 'core' and a 'periphery' stuck in poverty. Risks of such tendencies have attracted much attention since the EU was enlarged to include Greece, Spain and Portugal as well as in the context of developing the internal market and EMU. The EU cohesion policy, which has been financially significant since 1989, is meant to ensure that all regions benefit from deepening integration.

Roughly one third of the Community budget is channelled through the Structural Funds and the Cohesion Fund (with a 90/10 per cent split between them). The Structural Funds allocate money on the basis of 'objectives' to projects in eligible regions, while the Cohesion Fund transfers money to member states with a low level of GNP per capita for the financing of environment and transport infrastructures.

The effectiveness of cohesion policy in fostering convergence is a contested issue. There are some spectacular successes (Ireland) as well as significant failures (Mezzogiorno). Tabellini (2003: 88), referring to Boldrin and Canova (2001), probably expresses a representative view of economists in writing:

> But careful empirical studies have shown that, on average, structural and cohesion funds have not influenced economic performance: from a statistical point of view, recipient regions have had the same growth rate (or the same unemployment rate) as the rest of the sample … If the goal of these programmes was to accelerate economic convergence of poor regions, on average this goal has been missed.

Pinder (2001) notes that the funds were originally created as side-payments to the southern countries to facilitate agreement in bargaining situations and to achieve some redistribution from rich to poor territories. However, regional policy, with conditionality attached to various objectives, is a complicated and arguably wasteful way of accomplishing such transfers. One might think that it allows 'two birds to be killed with one stone', but it may also cause confusion and inefficiency (if not waste and fraud). Also, member states themselves are better placed to implement regional and other redistributions than the Community: thus the suggestion of, for instance Tabellini (2003) and Sapir *et al*. (2004), to renationalise regional policy and opt for a simpler redistribution policy between member states instead.

The future of cohesion policy and of the funds is presently a hot issue, not least in view of enlargement, which calls for a big increase in financing and/or severe cuts in funding going to the present beneficiaries in the south of the EU, and given the unwillingness of northern net payers to shoulder any additional burden for the financing of EU expenditure. No doubt much discussion is needed before unanimous agreement is reached between all twenty-five member states on the next Financial Perspective.

The regional policy of the EU has numerous supporters but also its critics. Many stakeholders, including the Commission, argue that regional policy is needed and has been successful, and that sufficient resources for regional policy must also be safeguarded in the enlarged union so as to allow reasonable aspirations to be met in both new and old member states. Many economists, on the other hand, dispute the results of regional policies and consider that structural and cohesion funds have failed to influence or improve the economic performance of lagging regions (see Box 9.1). The World Bank recently went as far as characterising EU regional projects as 'ineffective, based on incorrect or at least unsubstantiated economic theory, badly designed, poorly carried out and in most cases a source of wrong incentives'. Anyway, it may be argued that subsidiarity calls for a clear distinction between redistribution within the EU from one member state to another, and redistribution within member states from one region to another. The former is a legitimate objective for the Community and can only be decided upon at the EU level. Decisions on the latter, however, could, and arguably should, be left to the member states concerned. It may be considered appropriate that the objectives for redistributional policies should be defined by national political authorities, and national governments, and local authorities are likely to be better placed to use pertinent information and to design solutions appropriate to local conditons.

9.2.3 Stabilisation and the Community budget

It used to be argued that the EU needs a much larger budget to achieve a higher degree of macroeconomic stabilisation.[4] A bigger budget would in itself provide some macroeconomic stabilisation as member states in a recession would pay less to the Community budget (because of a lower GDP) while member states experiencing a boom would pay more (because of a higher GDP). Also, backed by bigger resources the Community could aim at some discretionary stabilisation through tax decisions or spending programmes at Community level. Such stabilisation efforts could relate to the overall economic development in the EU or could be targeted at countries, regions or sectors experiencing particularly severe problems. This line of reasoning is occasionally invoked by those arguing in favour of a strong political authority or an 'economic government' in charge of macroeconomic policy in the EU or the euro area (and to act as a political counterpart to the ECB).

On balance, however, this case for a big budget is not a strong one. First, the euro area already has a single monetary policy which is, or can be, geared to area-wide stabilisation. Second, fiscal policy is and should remain a national prerogative because it allows responses to country-specific disturbances that cannot be dealt with by monetary policy. Also, considerable automatic stabilisation can and does take place through national budgets. Third, experiences of fiscal fine tuning have been predominantly negative at the national level and might well be even worse (if tried) at Community level (see Chapter 6).

9.3 Financing the Community budget

The treaty stipulates that, 'Without prejudice to other revenue, the budget shall be financed wholly by own resources' (Article 269). The own resources may be defined as tax and other revenues allocated once and for all to the EU and accruing to it automatically without the need for any subsequent decisions by the national authorities. The 'other revenues' being very small, the expenditures of the Union are in practice financed by the OR defined in the Own Resources Decision (see Table 9.2). More particularly, as the significance of the agricultural levies and customs duties (the 'traditional' OR) as sources of revenue has declined over time as a consequence of trade liberalisation, the VAT resource and particularly the GNI-based contribution now constitute the main revenue sources.

The OR-system is in practice somewhat complicated. First, the traditional OR belong to the Community but member states are entitled to 25 per cent of the proceeds as compensation for costs of collection and administration. Second, the VAT resources are capped in the sense that a member state's VAT-base may not exceed 50 per cent of its GNP in the calculation of its VAT payment. Third, and above all, a budget adjustment system for the UK has been in force since 1985. The 'UK rebate' gives back 66 per cent of the difference between the share of the UK in VAT payments and its share of expenditure for the same year. This mechanism was further complicated in 1999 by provisions to ensure that the UK rebate does not increase the net payments of Germany, Austria, the Netherlands and Sweden. The obvious next step is a 'generalised correction mechanism' defining a cap on the net payment position which is applicable to all and any member states.

Proponents of deep integration in Europe have for a long time been suggesting that the expenditure of the EU should largely be financed by proceeds earmarked for that purpose. In practice, this could be a fraction of the personal income tax base or of the VAT base. Alternatively, it could be a specific tax wholly or primarily assigned to the Community. Suitable candidates for taxes that could be earmarked for the purpose of financing the Community include elements of corporate or capital taxation. For these, it is often difficult to establish unambiguously the appropriate geographical allocation of the tax base as multinational

Table 9.2 Community revenues, budget 2004 (EU 25)

	bn euro	*% share*
Agricultural levies and customs duties	11.4	11.4
VAT-resource	14.3	14.4
GNI-based contribution	73.2	73.4
Total ORs	*98.9*	*99.2*
Other revenue	0.8	0.8
Total revenues	*99.7*	*100*

companies can reshuffle profits across tax jurisdictions to minimise the tax burden (see Chapter 8). Another possibility would be to assign revenues from some environmental taxes with cross-border dimension to the Community (such as a CO_2-tax).

The lack of clear visibility of the financing of the EU means that there is presently no discernible relation, from the point of view of citizens, between Community policies and the taxes that pay for them. The existence of an identifiable 'EU tax' would introduce a clear link between revenues and expenditures and would thereby add to the transparency (and, perhaps, the legitimacy) of Community action. Also, the incentives of the European Parliament would be modified: it is now a forceful lobby for increased EU expenditure because it has no responsibility for the revenue side. Establishing a clear link between revenues and expenditure could only be helpful in broadening the scope of considerations relevant for opinions in the Parliament. There is, however, little political will among member states to go in this direction.

All in all, the Community budget is of modest size, but this is arguably not the main problem. More problematic is that most Community expenditure is spent on policies, notably on the CAP, which have no clear economic rationale, and which might better be left to decisions by member states (within an agreed framework of Community rules). Also, considerations of efficiency and subsidiarity suggest that the EU should focus on redistribution between member states while leaving internal redistribution, including regional redistribution, to member states and their local authorities. Instead, the EU could and should have higher ambitions in the provision of public goods, including in the areas of external defence and foreign policy as well as internal security.

10
Problems and Prospects

The EU has had its ups and downs: progress in economic and political integration was for many years modest until the mid-1980s, whereafter followed a period of bold decisions leading to a much improved internal market and the setting up of EMU. Since the start of the economic slowdown in the year 2000, the EU seems to have entered a new phase of weakness. Recent years have witnessed, *inter alia*, slow or no economic growth, renewed increases in the rate of unemployment, and a reversal of the catching-up process relative to the USA. While enlargement must be deemed a great historical achievement, Europe suffers from lack of leadership, reflected in quarrels over foreign policy, and inability to agree on the institutional reform needed to ensure its effective functioning. The perception of the EU is coloured by impressions of weak performance and weak governance. Should one conclude that the institutional structure of the EU is unable to face up to the challenges posed by integration and global competition?

While there is no unambiguous yardstick, it is indeed difficult to avoid the verdict that the economic performance of the EU in recent years must be deemed unsatisfactory and disappointing. Monetary and financial stability has improved since the euro was introduced, and it was hoped that this would pave the way for favourable macroeconomic developments. However, stability has so far not been accompanied by satisfactory economic growth and job creation. The EU economy seems stagnant or sclerotic when compared to or looked at in the light of the dynamic performance of the American economy (section 1). The reasons for the weak performance are manifold and subject to debate within the Union, not least in the context of the Lisbon process. Given the allocation of competences, the roots of the problem must primarily be sought in the conditions and attitudes at the level of member states and the failure of governments to undertake much-needed structural reforms. However, lack of effective action at EU level is part of the problem, and it is therefore important also to reflect on the weaknesses of the system of economic governance currently in place in the EU (section 2).

While the problems and weaknesses of the EU's economic performance and governance are undeniable, the present sentiments of doom and gloom may reflect excessive pessimism. A less sombre perspective is that Europe has some fundamental strengths, and that these support the appreciation that its economy may in coming years turn out to be more resilient and able to sustain more growth than recent developments might suggest.

10.1 Economic performance

This section aims at giving a concise overview of key features of economic developments in the EU, and to put them into perspective by comparing them with corresponding developments in the USA. Attention is first given to monetary and financial stability as well as cyclical developments and macroeconomic policies. Focus is then shifted to growth and productivity developments in Europe relative to the USA in a longer-term perspective as well as to the policy dimensions highlighted in the Lisbon agenda.

10.1.1 Stability and macroeconomic policy

There is no doubt that stability is a main concern and priority in policy deliberations in the EU. The treaty obliges member states to pursue policies compatible with monetary and financial stability, fulfilment of stability criteria is a precondition for joining EMU, and successive BEPGs have insisted on the importance of stability-oriented macroeconomic policies. While the appropriate level of ambition is a matter of debate and appreciation, it seems clear that the EU has indeed made considerable progress in the pursuit of stability during the past decade. This is seen from Table 10.1, which summarises, for the EU or the euro area and the US, the development with regard to the stability indicators (or 'convergence criteria') that have been a focal point in the EMU process.

Average *inflation* in the EU has not exceeded 3 per cent in any year during the past decade. Inflation in the southern member states (Greece, Italy, Spain and Portugal) declined dramatically as part of the run-up to stage 3 of EMU. Only Spain, Portugal and Ireland have experienced inflation exceeding 3 per cent in some of the recent years, and much of this is understandable in the light of cyclical positions and/or a catching-up process. Most observers agree that price stability has by now been largely achieved and is relatively well established in the EU, though the ambitious inflation target set by the ECB, that inflation should be below 2 per cent, has not been fully achieved. Inflation in the euro area has in fact marginally exceeded that target in most years since the ECB was set up.

As far as the state of *public finances* is concerned, the picture is mixed. The general government financial deficits of certain member states, notably France and Germany (as well as Portugal, Greece, and Italy), have attracted much attention and criticism recently, and budget positions in the euro area have not converged to balance or surplus in the medium term as called for by the SGP. These developments are unsatisfactory in view of, *inter alia*, the financial challenges related to aging populations. However, on average budget deficits of EU member states were much smaller in the period 1999–2004 than in any five-year period since the first oil crisis. Also, average EU budget developments compare favourably with the USA (not to mention Japan); after the budget surpluses of the Clinton years, the US budgets have swung back into large and rapidly increasing deficits. Government debt in the EU is (regrettably) not on a clear downward trend, but the debt ratio is now higher than it was ten years ago.

Table 10.1 Stability

	Inflation		*Budget balance*		*Government debt*	*Long-term interest rate*	
	EU	*USA*	*EU*	*USA*	*EU*	*Euro area*	*USA*
1994	2.8	2.6	–5.6	–3.6	66.1	8.0	7.1
1995	2.8	2.8	–5.4	–3.1	70.5	8.4	6.6
1996	2.4	3.0	–4.3	–2.2	72.3	7.1	6.4
1997	1.7	2.3	–2.5	–0.9	70.9	5.9	6.4
1998	1.3	1.6	–1.8	0.3	68.7	4.7	5.3
94–98	2.2	2.4	–3.9	–1.9	–	6.8	6.4
1999	1.2	2.2	–0.8	0.7	67.8	4.6	5.6
2000	1.9	3.4	0.7	1.4	63.9	5.4	6.0
2001	2.2	2.8	–1.1	–0.5	63.0	5.0	5.0
2002	2.1	1.6	–2.0	–3.4	63.1	4.9	4.6
2003	2.0	2.3	–2.7	–4.9	65.0	4.2	4.0
99–03	1.9	2.5	–1.2	–1.3	–	4.8	5.0

Source: OECD (2003c: Annex Tables 28 and 36) for budget balance and interest rate; and Eurostat (website) for inflation and debt.

The development of *long-term interest rates* confirms the assessment of an improvement in financial stability. Long-term interest rates in the member states of the euro area have declined substantially since the single currency was introduced and the ECB set up. Also, interest rates have since then mostly been lower than in the USA, while the converse was true in the 1994–98 period.

The consensus view, reflected in the BEPGs, is that stability should pave the way for healthy economic growth. However, the growth performance of the EU has been poor in the last decade (Table 10.2). Growth in the euro area was barely above 2 per cent in the years 1994–98 (as compared to almost double this in the USA), and it has been even weaker since then[1] (notably in the years 2001–03). As a consequence, output in the euro area has mostly been below its potential level (negative output gap). This contrasts with the USA, where policy activism has kept actual output on average above its potential level in spite of the more rapid growth of potential output in the USA as compared to the euro area (assessed at some 3 per cent and 2 per cent respectively by the OECD).

Table 10.2 Macroeconomic policy

	Fiscal policy indicator		*Change in real real short-term interest rate*		*Growth of GDP*		*Output gap*	
	Euro area	*USA*	*Euro area*	*USA*	*Euro area*	*USA*	*Euro area*	*USA*
1994	0.2	0.9	–1.7	1.9	2.4	4.0	–2.1	–0.5
1995	–0.1	0.7	0.5	1.1	2.3	2.7	–1.7	–0.6
1996	1.1	0.4	–0.5	–0.7	1.4	3.6	–2.3	–0.1
1997	1.1	0.7	0.1	0.9	2.4	4.4	–2.0	0.9
1998	–0.3	0.9	0.1	0.6	2.8	4.3	–1.3	1.8
94–98	0.4	0.7	–0.1	0.8	2.3	3.8	–1.9	0.5
1999	0.1	0.0	–0.9	–0.8	2.8	4.1	–0.6	2.5
2000	–0.5	0.6	0.4	–0.1	3.7	3.8	0.9	2.2
2001	–0.7	–1.5	–0.3	–2.2	1.7	0.3	0.3	–1.0
2002	–0.3	–3.2	–1.0	–0.7	0.9	2.4	–0.8	–1.3
2003	0.0	–1.7	–0.8	–1.5	0.5	2.9	–2.2	–1.5
99–03	–0.3	–1.2	–0.5	–1.1	1.9	2.7	–0.5	0.2

Key: Fiscal policy indicator = change in cyclically adjusted general government balance (– = expansionary, + = restrictive). Real interest rate = nominal rate less inflation (from Table 10.1).
Source: OECD (2003c: Annex Tables 1, 11 and 31)

There are some striking contrasts between the euro area and the USA with regard to the ambitions and role of macroeconomic policies. *Fiscal policy* in the member states of the euro area was tightened in the run-up to stage 3 of EMU in the 1994–98 period. The cyclically adjusted primary balance improved cumulatively on average by 2 per cent from 1993 to 1998, and by much more in some member states. Since the start of stage 3, by contrast, fiscal policy has on average been eased somewhat (cumulatively by 1.4 per cent between 1998 and 2003). In the USA, fiscal policy was tight until the year 2000, but has since turned vigorously expansionary; the cumulative swing of the primary balance since 2000 is as much as 6.4 per cent, an exceptionally strong impulse of fiscal expansion.

The difference in *monetary policy* is equally striking: in the former period (1994–98) it was on average largely neutral in the member states of the euro area, while it was clearly restrictive in the USA. In response to the sharp cyclical slowdown, the US Federal Reserve Bank (the 'Fed') in the years 2000–03 cut the interest rates under its immediate control by a cumulative 550 basis points (as compared to 275 basis points by the ECB). This constitutes an exceptionally strong impulse of monetary expansion, and real short-term interest rates in the USA similarly declined in the same period by more than 5 percentage points. More recently (in early 2004), the expansionary monetary policy stance in the USA has also been reinforced by a rapid and substantial depreciation of the exchange rate of the dollar, the monetary easing in the euro area being correspondingly mitigated by a strengthening of the euro.

Macroeconomic management in the USA as compared to the EU reflects different institutional conditions as well as different conceptions of the role of policy. Fiscal policy in the euro area is member state competence, and the EU cannot overall react to cyclical developments as quickly and forcefully as the US Government can through the federal budget. On the other hand, the public sector is bigger in Europe than in the USA and the automatic stabilisers are therefore more significant, which reduces the need for discretionary stabilisation policy. Also, the room for manoeuvre of fiscal policy in Europe is constrained by the fiscal policy rules as well as by concern about the long-term sustainability of public finances in view of the problems associated with ageing populations. As to monetary policy, the Fed has a well-established position and can allow itself more flexibility than the ECB, a new institution geared to establishing credibility for its commitment to price stability.

There are also some interesting doctrinal differences. The present US administration pursues an aggressive fiscal expansion and shows little concern for the ultimate consequences of large and rapidly increasing federal budget deficits (though this situation may change once the next presidential elections are over). This contrasts with the doctrine in Europe, which lays emphasis on automatic stabilisers rather than discretionary activism. Somewhat similarly, the ECB has tried to keep monetary conditions favourable and steady, while the Fed has been running a vigorously proactive monetary policy with a view to keeping aggregate demand close to the level of potential output. By doing so, the Fed has at times contributed to or accommodated a build-up of 'bubbles' in asset markets and sizable financial imbalances. Such developments risk having negative repercussions in the longer term and may ultimately undermine stability and growth. While the results of US policy activism are impressive, it may be argued that the 'jury is still out' and that the benefits can be properly evaluated only when the 'twin deficits' (the budget and the current account deficit) have been brought under control and long-term financial sustainability restored.

10.1.2 Growth and employment

Weak growth in Europe would not be a source of great concern if one could safely assume that the problem were temporary. Unfortunately, this does not seem to be the case. As seen from Table 10.3, growth has been on a declining path in the EU over decades, and growth is now markedly lower than in the USA. It is important to note that population growth is also persistently lower in Europe than in the USA, and per capita growth of output has been roughly the same in the EU and the USA over long periods. However, this is no real comfort because one should actually expect per capita growth to be more rapid in Europe than in the USA as part of a catching-up process. It should be easier to achieve rapid growth for countries that are further away from the technological frontiers (as is the case for Europe as compared to the USA). In fact, developments in Europe in the years 1950–73 were truly remarkable: GDP per capita in the EU15 rose from 40 per cent of the level in the USA to some 70 per cent at the end of the period. At the same time, both inflation and unemployment remained fairly low. Growth per capita was still 1 per cent more rapid than in the USA in the years 1961–80. However, the catching-up seems to have come to an end since then; worse, growth per capita in the EU has in recent years been clearly lower than in the USA.

Table 10.3 Long-term growth

	GDP			*Population*			*GDP/capita*		
	EU	*US*	*diff.*	*EU*	*US*	*diff.*	*EU*	*US*	*diff.*
1961–80	3.9	3.7	0.2	0.6	1.2	–0.6	3.3	2.5	0.8
1981–90	2.4	3.2	–0.8	0.3	1.0	–0.7	2.1	2.2	–0.1
1991–95	1.6	2.4	–0.8	0.4	1.3	–0.9	1.2	1.1	0.1
96–2000	2.7	4.1	–1.4	0.3	1.3	–1.0	2.4	2.8	–0.4
2001–03	1.0	1.9	–0.9	0.4	0.6				

Source: Commission (2003a, 2004a).

It is of some interest to examine the development of GDP per capita in the EU as compared to the US by breaking it down into main components. As seen from Table 10.4, the relative level of GDP per capita in the EU has been roughly unchanged at some 70 per cent of the US for several decades; at the same time there have been large differences in the developments of labour productivity, working hours and employment rates.

The average productivity of labour in the EU has increased from 65 per cent to more than 90 per cent of the US level in the 1970–2000 period. In fact, there are several member states of the EU (Belgium, France, Italy and the Netherlands) where output per hour is now higher than in the US. However, the stronger productivity developments in the EU are offset by an equally marked trend towards less work: average working hours per employee have decreased by 15 per cent in the EU as compared to the US, and employment (as a share of the population of working age) has similarly declined by 15 per cent relative to the US. Europeans are (in relative terms) more and more productive and work less and less.[2] One interpretation of this might be in terms of differences in preferences. European societies presumably give more weight to leisure in the form of short working hours (including more part-time working), long vacations and early retirement, as compared to Americans who value material goods more highly. If so, the weak economic performance of Europe is not to be deplored but could to be seen as reflecting rational choices giving expression to these preferences. However, it is remarkable that the employment rate is roughly the same for prime-age males in the EU and the US (see table 10.5), but is much lower in the EU for young and old workers, notably for women. It is not at all obvious that differences in preferences explain this; as reported in

Table 10.4 GDP per capita in the EU relative to the USA

	1970	*Cumulative change, %*	*2000*
1. GDP/population	69.0	1.9	70.3
2. GDP/working hours	64.8	40.0	90.7
3. Working hours/employed persons	101.0	–15.2	85.6
4. Employment/working age pop.	103.6	–15.4	87.6
5. Working age pop./population	101.7	1.7	103.4

Source: Sapir *et al.* (2004).

Sapir *et al.* (2004), it is probable that involuntary part-time work is one factor, and more generally, that differences between the EU and the USA stem mainly not from differences in preferences but from a lack of employment incentives and opportunities in Europe. These are related, *inter alia*, to generous pension benefits and early retirement schemes, high tax rates on labour income, and labour market institutions protecting insiders while making it difficult for the unemployed and for new entrants to the labour market to compete for jobs.

Indirectly, though, preferences of society are inevitably an important determinant of employment rates because they are reflected through the political process in important decisions on economic and social policies. It cannot, however, be assumed that the decisions emanating from the political system, including policy decisions with important consequences for labour markets and employment, give expression in some straightforward way to the preferences of individuals. As seen in Chapter 3, the outcome of collective choice has no simple relation to the preferences of the individuals forming the collectivity. It may well be that individuals would prefer better job opportunities (even at the cost of some security), yet the political process may result in decisions stifling enterprise and job creation. Be that as it may, part of the problem of unemployment in Europe is most likely due to regulatory policies, social protection and high taxes. These policies reduce flexibility in labour markets and the capacity of the economy to adapt to changing circumstances with regard to, for instance, technologies and global market conditions.

They do so by reducing incentives to offer and take up work, by facilitating early retirement, by making it more costly to set up and operate small enterprises or to generate and exploit innovations. The European model gives a high priority to security relative to flexibility, and it is

Table 10.5 Employment rates

	Male		*Female*		*Total*	
Age	*EU*	*US*	*EU*	*US*	*EU*	*US*
15–24	45	62	37	58	41	60
25–54	88	89	66	74	77	81
55–64	49	66	28	50	39	58
15–64	73	81	54	68	64	74

Source: Sapir *et al.* (2004).

experiencing increasing difficulties as a consequence of the combined effects of lack of dynamism and ageing populations. It cannot cope satisfactorily with the pervasive changes in the organisation of knowledge-based production (with large scope for outsourcing of activities globally). Its viability is undermined by negative feedbacks between high tax rates and social costs on the one hand and weak growth and job creation on the other.

All EU member states face the challenge of transforming their economies with a view to more dynamism and flexibility while safeguarding objectives in other areas such as social protection, education and the environment. In Lisbon in 2000, the European Council agreed that the EU should aspire by 2010 'to become the most competitive and dynamic knowledge-based economy in the world capable of sustainable economic growth with more and better jobs and greater social cohesion'. An environmental dimension was added to this Lisbon agenda in 2001. As noted in Chapter 4, there are a number of Community activities and coordination procedures that report to the annual spring meeting of the European Council about progress towards the strategic objective.

As part of the work on the Lisbon agenda, the Commission annually produces a set of structural indicators to facilitate a quantitative evaluation of progress and to identify useful 'benchmarks' and 'good practices' in various policy areas. The set of indicators is defined and agreed jointly by the Commission and the Council. The indicators may be of interest not only for the light that they shed on various aspects of developments in member states, but also because, to some extent, they give expression to what member states and the Commission agree to consider as being of particular importance from the point of view of achieving the Lisbon objective. This is even more the case for a subset of the indicators, the 'headline indicators' or the 'shortlist', which are agreed for the annual spring report that the Commission presents to the European Council.

The results of the 'Lisbon beauty contest', as reported in the spring report 2004, are set out compactly in Table 10.6. The table shows for each dimension (rows) the ranking of member states (columns) in terms of their relative performance as well as the sign of the difference of the US average as compared to that of the EU. Thus, row 1 shows that GDP per capita in purchasing power standards (PPS) in the EU is presently highest in Luxembourg, Ireland and Denmark (in that order) and lowest in Spain, Greece and Portugal. Similarly, the good performers in terms of the employment rate include Denmark, Sweden and Netherlands, while the laggards include Spain, Greece and Italy. The USA performs better than the EU on average with regard to both GDP per capita and the employment rate.

While the ranking of member states in any particular dimension has a relatively clear meaning, it is much less clear what one may conclude from the 'average' performance over indicators. Notwithstanding this ambiguity, the next-to-last row in Table 10.6 shows the ranking of member states in terms of a simple average of the performance in the various dimensions. This 'beauty contest' is won by Denmark, followed by Sweden and Austria, while the bottom positions go to Italy, Greece and Spain. In general, there is a rather strong north–south correlation with better ranking for the northern countries, though Belgium, Germany and Finland do less well than their geographical location would suggest.

One purpose of the structural indicators is to stimulate competition with a view to laggards catching up with the front-runners. The last row in the table shows the average ranking of member states with regard to the change in their performance since 1999 (when the Lisbon agenda was defined). As is seen, some catching up is taking place, with several countries with a weak 'relative performance' scoring much better when compared in terms of 'relative improvement'. This is the case notably for Greece, Spain, France and Belgium, while countries with a deteriorating relative position include Austria, Germany, Denmark, the Netherlands and Luxembourg.

Most importantly, the same is true for the EU on average as compared to the USA. The relative performance of the USA is better than for the average of EU member states (as indicated by the plus signs in the last column) for all indicators for which information is available except the environmental ones.[3] However, the EU is, despite the weak economic developments in recent years, experiencing some catching up (as indicated by the more frequent minus signs in brackets).

Table 10.6 Relative performance of member states (structural indicators)

	AU	*BE*	*GE*	*DE*	*SP*	*FI*	*FR*	*GR*	*IR*	*IT*	*LU*	*NE*	*PO*	*SW*	*UK*	*USA*
GDP per capita (PPS)	4	7	11	3	13	10	9	14	2	12	1	5	15	8	6	+ (–)
Labour productivity	8	3	11	7	11	6	4	14	2	5	1	13	15	10	9	+ (+)
Employment rate	5	12	8	1	13	7	11	14	8	15	10	2	6	3	4	+ (–)
– older workers	12	15	10	2	8	6	11	8	5	13	14	7	4	1	3	+ (–)
Educational attainment	4	6	9	11	14	1	6	5	2	12	13	9	15	3	8	n.a
R&D expenditure	7	5	3	4	13	2	5	15	11	12	10	7	14	1	9	+ (–)
Business investment	3	5	11	7	1	13	12	4	9	7	6	10	2	15	14	n.a
Comparative price levels	8	5	10	15	3	14	6	2	13	4	6	8	1	12	11	– (–)
Risk of poverty	6	8	2	2	11	2	9	13	15	11	6	2	13	1	10	n.a
Long-term unemployment	2	11	13	4	12	9	10	14	7	15	2	1	8	5	6	+ (–)
Regional empl. dispersion	2	10	6	?	11	9	7	4	?	12	?	1	3	5	8	n.a
Greenhouse gas emissions	11	10	2	5	14	7	5	12	13	7	1	7	15	4	3	– (–)
Energy intensity of economy	2	11	4	1	10	15	6	14	3	5	7	8	13	12	9	– (+)
Volume of freight transport	11	7	8	1	15	4	5	13	14	9	10	6	12	2	3	– (+)
Average position	3	11	9	1	15	7	8	14	10	13	5	4	12	2	6	
Average change in position since 1999	13	3	15	8	7	6	1	3	10	9	14	11	12	5	2	

Note:
Last column shows USA compared to the EU average, change in the US performance compared to the average of EU member states since 1999 in brackets (+ = USA better than EU).
Source: Commission (2004b).

While the pronounced economic weakness in the early years of this decade has given rise to sentiments of doom and gloom in Europe, there are actually some grounds for cautious optimism. First, the improved stability of the European economy has strong foundations, and this should allow growth, once resumed, to be better sustained than in the past. Growth should in these conditions run fewer risks of being undermined by a resurgence of inflation and inflationary expectations, by exchange-rate tensions or by interest-rate hikes.

Second, while progress in the area of economic reform has been too slow, it is noteworthy that structural reforms are now high on the political agenda all over the EU, and that important reforms have in recent years been achieved and are being undertaken in member states. Assuming that this trend continues or is reinforced, one may increasingly expect pay-offs in the form of better growth performance and more employment.

Third, recent research suggests that the monetary union may, in the long run, have strong positive effects on trade and thereby also on prospects for growth of output.[4] While economic prospects are always associated with many risks, the present pessimism in Europe seems excessively coloured by the prolonged cyclical weakness recently experienced. Once growth resumes, sentiments may change and the European economy may turn out to be more resilient and capable of more robust growth than suggested by its performance in the recent past.

10.2 Economic governance

This section shifts the attention from economic performance to economic governance. As underlined in Chapter 4, the EU relies on four main methods for involving the Community level in the process of economic policy-making: economic policy coordination, the Community method (notably in legislation), delegation of some discretionary power to a specific supranational body (such as the ECB), and the Community budget. These methods and the modalities for their implementation by the member states and the Community institutions constitute the EU's system of economic governance. This section discusses the strengths and weaknesses of that system. It does so by first defining criteria of good governance (section 1), and by examining the benefits and costs of the different methods as a basis for some conclusions on the system of economic governance as presently operated in the EU (section 2).

10.2.1 Criteria of good governance

The EU's system of economic governance, set out in earlier chapters, involves many actors and is based on a variety of methods, each with its own instruments and procedures. Views on the adequacy of this system differ: some believe it is too weak to allow the EU to face up to the challenges of interdependence and globalisation; others think that the real issue is how to deal with the structural problems which, while having common elements for all EU countries, must essentially be examined and addressed at the national level (because of country-specific institutions and traditions). Without prejudging any views on this, one may rather raise the more basic question of how a system of economic governance should be evaluated. One answer is to stress the following as criteria of a good system of economic governance:

Subsidiarity and adequacy. The most important requirement that the EU should fulfil is that of focusing its attention and activity on the 'right' issues. This means that subsidiarity should apply properly. As is known, subsidiarity has a double aspect: it calls for matters to be left to national and/or local authorities unless there is a strong presumption that the problem at hand requires action at the Community level for effective solutions to be possible. Any EU action in the area of economic policy should thus have a clear rationale in the sense discussed in Chapters 1 and 2; that is, there should be some market failure with a cross-border dimension.

The requirement of subsidiarity is often understood as a defence against intrusion by the EU into issues that arguably should be seen as national matters. While not wrong, it needs to be understood that this aspect is counterbalanced by the second aspect, which calls for action at Community level when national action is not enough to deal with cross-border issues (for the requirement of 'adequacy' to be fulfilled).

Effectiveness and efficiency. It is obvious that action should aim at effectiveness in the sense of achieving its objectives. Action should also be efficient in the sense of achieving results with as little use of time and resources as possible (with a high output/input ratio). Effectiveness is certainly much enhanced if the requirement of subsidiarity is met. It is also conditional on the methods of action available at EU level and on the political support of all stakeholders and actors. Efficiency calls, *inter alia*, for keeping the focus on concrete action rather than wasting time on generating declamatory resolutions without operational significance (as 'talk is cheap').

Coherence and consistency. It is essential that actions in different parts of the system of economic governance should be consistent in the sense of forming parts of a coherent whole. Coherence can be ensured by centralisation, but it can also be achieved in a decentralised framework provided that there is a division of labour and roles (assignment of different tasks to different actors) and/or sufficient coordination. Horizontal coordination is needed to ensure coherence of action across sectors. Otherwise much energy risks being wasted on unproductive quarrels and rivalry between proponents of sectoral interests. Vertical coordination should ensure that actions at different levels (member states, the Council, the European Council) are mutually consistent, otherwise decisions at the top (the European Council) risk being devoid of significance. Coherence of action over time calls, *inter alia*, for planning and coordination between successive presidencies, otherwise actions risk being confused and perceived as lacking direction.

Simplicity, transparency and accountability. It is desirable that the system of governance should be simple and transparent as preconditions for accountability. It is obviously difficult for governance to be simple if conflicting requirements necessitate complex arrangements. However, a fair amount of technical complexity may be acceptable as long as the essential chains of command and accountability are comprehensible. Such transparency may be enough to pave the way for accountability, meaning that there is some feedback with regard to actions by decision-makers in the form of reporting and evaluation (and possibly through actions exercising political control). The forms of accountability that are needed will depend on the scope of power conferred to the system of governance, and the achievement of the ultimate objective of acceptability and legitimacy is also enhanced if the decision-makers are widely perceived as professionally competent and successful.

There are obviously complex interrelations between these criteria of good governance. Sometimes they are mutually supportive. For instance, transparency should make it easier to achieve coherence, and respect for subsidiarity helps achieve efficiency. In other cases there may be a trade-off between fulfilling the criteria. For instance, some simplicity and accountability may be lost in an endeavour to enhance effectiveness, or efficiency may be impaired by a very strict insistence on horizontal coordination.

While there are trade-offs, it is nevertheless difficult to avoid the impression that the EU system of (economic) governance does not perform too well, or scores worse than it should, in these important dimensions. (Some illustrations have been given in earlier chapters.) It is all too easy to point to legislative initiatives for which there seems to be no clear rationale in the form of significant cross-border spillovers. Equally, there are important common problems which are not addressed effectively. Furthermore, there can be no doubt that much Community action has become the victim of bureaucratisation with effects detrimental to efficiency, while also adding to complexity and lack of transparency. Horizontal coordination is notoriously weak in the Council, the General Affairs Council lacking the means or the will to ensure coordination, but often in the Commission as well (though the college of the Commission should ensure it). Performance in the accountability dimension must be deemed even worse. The complexity and lack of transparency of EU decision-making is occasionally such that only insiders are in a position to follow and understand what is going on. There is indeed much to deplore in the way that the EU operates.

Historically, the EU has been a machine run by experts within the framework of a technocratic structure. Its legitimacy has been based on professional competence and results (and shared values) rather than on considerations of transparency and accountability (or procedural legitimacy). Given the wide scope of EU activities today, and their significance for households and businesses all over Europe, the demands for transparency and democratic accountability will inevitably have to be taken much more seriously. However, the question of how to anchor the EU with its citizens is obviously an issue which goes far beyond the present discussion of the problems of economic governance.

10.2.2 Multimethod governance

The difficulties of fulfilling the criteria of good governance go a long way towards explaining the fact that the EU needs to apply several methods in its economic governance. Each of these score differently with regard to the criteria reviewed above, and jointly they allow the system of governance to do better than otherwise. Some observations on the strengths and weaknesses of the different methods follow.

Economic policy coordination may suffice if spillovers are small and if the purpose of action at the EU level is mainly to disseminate information and to exchange experiences, views and ideas. There is no doubt that dialogue at Community level occasionally gives valuable impulses to the participants and thereby exerts a beneficial influence on policy decisions in member states. However, policy coordination is not effective if binding decisions are needed. It is prone to bureaucratisation, and it has an inherent tendency to escalate as a consequence of sectoral rivalry (each sector wanting to establish its coordination process so as to generate material for consideration by the Council and the European Council). Also, policy coordination may sow confusion and blur responsibilities as citizens may fail to understand that it boils down to talking and wishing but does not amount to effective action at EU level with a view to concrete results. Equally serious is the frequently glaring disconnection between the deliberations (and rhetorics) of the Lisbon process from the political reality in member states.

The Community method is mainly used for Community legislation and is based on interaction between the Commission (initiative), the Council and the European Parliament (co-decision). The method is not simple but it is increasingly transparent and meets demands of accountability, as the decision can be influenced by the directly elected European Parliament as well as (ultimately) by national parliaments. Experience demonstrates that the method can perform well in terms of efficiency. However, this is the case mainly when QMV applies; prospects for progress are notoriously weak when unanimity is required for legislation to be passed. Another problem is that both the Council and the Parliament have a tendency to get bogged down in regulatory detail related to sectoral and country-specific concerns. There is much to be said in favour of introducing a clearer hierarchy of legal norms such that the co-decision procedure of the Council and the Parliament would focus on the main features of laws, while leaving details to be dealt with in administrative legislation at the responsibility of the Commission (as indeed suggested by the European Convention).

The Community budget performs relatively well with regard to transparency and accountability. However, it cannot really be assessed on its own terms as it is just the financial expression for decisions taken by other methods; it is the programmes covered by the budget which are the real issue. As pointed out in Chapter 9, it is a serious problem that much of the budget is spent on programmes for which the rationale may be questioned (such as the CAP and regional policies).

Delegation of discretionary power to a specific body is an option that is attracting increasing interest. It allows high efficiency to be combined with accountability provided that the power delegated is limited in scope (to the management of a particular task), that the delegation itself is decided in a democratic manner and that the exercise of power is monitored. Experience with the ECB may be deemed favourable.

Experience of delegation of specific powers to the Commission (such as in competition policy) is also positive but still open to debate. The problem is that the Commission is a multi-purpose institution with an ambitious agenda and policy objectives of its own. This situation might create conflicts of interest (or be perceived to do so) between the Commission as a body setting objectives and initiating legislation on one hand, and its role in enforcing existing legislation and policies on the other. The problem could be avoided by delegating the powers to a separate European authority (separate from the Commission), specialised in monitoring and enforcing policy in the particular area at hand.

As this short review serves to demonstrate, the different methods all have their pros and cons. The present institutional framework of economic governance may occasionally seem arbitrary and complex, but it responds to partly conflicting requirements and it has developed organically to meet genuine difficulties by differentiating the methods according to the character of the problems. There are several weapons in the arsenal (or colours in the palette), and this adds to the strength of the army (or the beauty of the picture).

While governance should comply with the above criteria, this in itself is not enough. It is also essential that each method of governance should be used for its appropriate purposes. An analysis of this issue needs to be based on an examination of the benefits and costs of the methods. These, it will be argued below, depend on the strength of the cross-border effects (giving rise to the problem calling for action), and the degree of supranationality of the proposed action.

It appears that the methods can, crudely, be ranked according to their degree of supranationality, referring by this to the scope for the member states to influence or block the decisions on the one hand, and the degree of 'bindingness' of any decisions arrived at on the other. Policy coordination clearly has the lowest rank on this scale, as decisions (if any) by this method are non-binding. Second in line is the Community method with unanimity, which allows any member state to block any decision perceived as violating its national interest. A relatively high degree of supranationality is a feature of the Community method with QMV and the method of delegation of power to a supranational body.

Another important dimension is the strength of the cross-border consequences of policies. These differ depending on the case and they obviously have a bearing on the benefits of Community action. In particular, weak spillovers imply a weak case for Community action and rapidly diminishing returns as the degree of supranationality of action is increased. Conversely, strong spillovers would imply a strong case for Community action and may justify choosing a method with a higher degree of supranationality. This point is illustrated (heuristically) in Figure 10.1, which shows the benefits of Community action on the vertical axis and the degree of supranationality of action (associated with the different methods) on the horizontal axis.

Needless to say, views on the appropriate interventions at the Community level should consider costs as well as benefits. Costs come in two main varieties: decision costs (time and other costs of negotiating a deal), and what in Chapter 3 were referred to as 'external costs' (basically redistributions between member states). Leaving the latter aside for the moment, one might reasonably assume that the costs of Community action are relatively lower for the cases of policy coordination (no binding decisions sought) and the delegation method, provided that the specialised body to which power is delegated is equipped with an efficient decision mechanism (not requiring unanimity). Costs are likely to be higher for the intermediate cases of the Community method, which is procedurally heavy, notably if decisions are by unanimity. This would imply that the costs are hump-shaped and that the costs and benefits of Community action, as a function of the strength of spillovers and the degree of supranationality, could be illustrated as in Figure 10.2.

There is one further practical consideration that needs to be introduced (even at this level of abstraction) before attempting to draw any conclusions. This is the observation that costs are very different for decisions

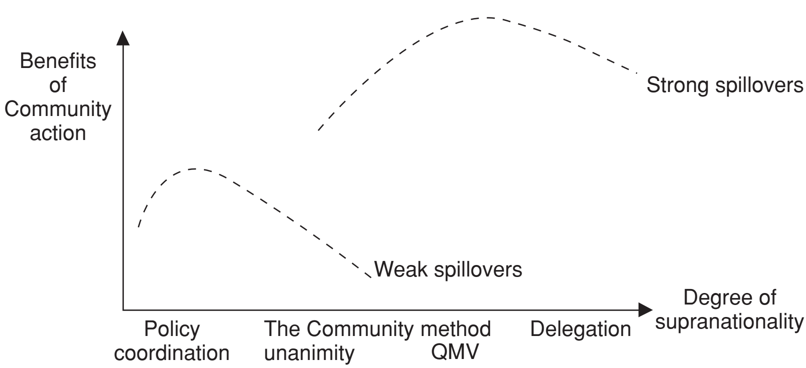

Figure 10.1 Benefits of Community action

on rules as compared to discretionary decisions. The latter are taken with relatively high frequency and their costs are therefore quite relevant. The former kind of decisions, by contrast, are taken once and for all or seldom; the costs, even if high, are spread out over a considerable time period and therefore are of less significance.

There are thus three main elements to consider, in addition to the criteria for good governance reviewed above, when evaluating the case for and the appropriate method of Community action: the benefits as a function of the strength of cross-border spillovers, the costs as a function of the degree of supranationality, and the difference between discretionary decisions and decisions on rules. A final consideration is the need to pay attention to any conflictual redistributive consequences ('external costs') that risk giving rise to conflict and undermining the cohesion needed for the institutional framework to function satisfactorily. Taking stock of these elements suggests the following conclusions.

First, policies in areas where decisions are needed with high frequency (because of the need for discretion to complement or substitute for rules) should be dealt with by one or the other of the 'extreme' methods in terms of the degree of supranationality: either policy coordination, which is appropriate in the case of weak spillovers, or delegation of power to a specialised supranational body, which is called for in the case of strong spillovers. (The degree of supranationality maximising net benefits is indicated by the dotted vertical lines in Figure 10.2.) The Community method, by contrast, is not well suited to deal with the kind of high-frequency deliberations and decisions (of

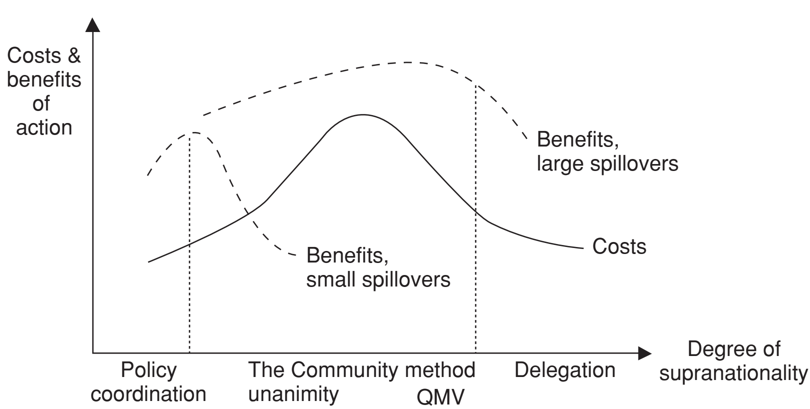

Figure 10.2 Costs and benfits of Community action

executive character) that such economic governance often calls for. The costs of co-decision of the Council and the Parliament, or of decision-making with unanimity in the Council, would be too high for such a method to be justified if policy parameters must often be reviewed and adjusted according to changing circumstances.

Second, the Community method is indeed justified for policy areas with high interdependence and big spillovers, provided that rules or laws suffice without there being a frequent need for exercising discretionary power. This is the case for the internal market but much less so for other areas of economic policy. It is important that decisions on binding rules, laws, are taken in a way which meets demands for accountability. Heavy procedures are not a key problem as long as laws need not be revised frequently. However, heavy and time-consuming procedures are a serious problem in areas where speed of decision-making is of the essence, and the Community method is not useful if at all applicable in such cases. Monetary policy according to the Community method would be a nightmare (the same no doubt holds for many decisions in the area of foreign policy).[5] It may be added that there is pressure to simplify the Community method so as to allow more rapid adjustment also of Community legislation in the face of changing circumstances.[6]

Third, decisions of a constitutional character, or which ultimately may have significant redistributive consequences, should remain within the unanimity requirement. Cases in point include, *inter alia*, the allocation of competences as well as the ceiling on the own resources of the Community and the principles with which its budget must comply. The costs of unanimity are high but worth paying if this safeguards rules of a constitutional character that alleviate member states' fears of being exploited by ruthless majority coalitions.

These conclusions also have some bearing on the rules-based fiscal policy framework in EMU. This framework is something of a mixture in that it relies on policy coordination, though that coordination should comply with rules agreed by the Community method. As recent experience illustrates (Box 6.3), this coexistence of methods is not always an easy one. The present system, policy coordination within a framework of binding rules, runs the risk of being both too much and too little: it is legally binding and impinges (somewhat) upon national sovereignty, yet is implemented with a high level of discretion and is not a very strong safeguard of budget discipline. Not surprisingly, there have been suggestions to develop the framework for fiscal policy in one or the other of the two possible directions.

In the late 1990s, the German government (at the insistence of its then finance minister Theo Waigel) argued strongly that fiscal policy should be based on legally binding rules with automatic financial sanctions (fines) for any budget deficits exceeding the 3 per cent reference value. The proposal aimed to do away entirely with discretion in fiscal policy, the underlying assumption being that discretion of such a political body as the Council would inevitably result in 'soft' decisions eroding credibility. While the initiative resulted in some secondary legislation and a European Council Resolution (which jointly constitute the SGP), it did not fundamentally change the discretionary character of the procedure for fiscal policy coordination.[7] This may be deemed fortunate, because in reality fiscal policy cannot be reduced to implementing a simplistic legal rule and asking the ECJ to make sure that it is enforced: fiscal policy cannot be run by an autopilot.

An attempt in the opposite direction is the idea, which has been put forward repeatedly by Jacques Delors and many others, of setting up an 'economic government' with wide-ranging powers to take discretionary decisions on fiscal and macroeconomic policy coordination issues in EMU. Delors (2004) would like to see a strengthening of the institutional position of the Commission in economic policy coordination, the setting up of a stabilisation fund at the level of the euro area, actions with a view to some harmonisation in taxation and social regulation, and decisions on a common employment strategy. In short, the EU should have the political will to set itself ambitious economic and political objectives as well as the power and instruments for taking action to achieve the objectives.

The counter-argument to this view (set out notably in Chapter 6) is that there is no need for such a government because the cross-border effects of economic policies (except for monetary policy) are unlikely to be of such a magnitude as to justify strong forms of Community action. Also, very heavy and time-consuming procedures would be needed if decisions were to be taken by unanimity, while risks for politically unacceptable consequences for individual member states would constitute a permanent threat to the viability of the system if decisions were to be taken by QMV. The EU has neither the need for a true government nor a method that could be used to make such a body operational. There are ways in which the fiscal policy framework might be refined, but there are no compelling reasons for considering it to be fundamentally flawed, and nobody has set out an alternative that could be seen as obviously superior.

It is pertinent to observe that the EU system of economic governance has changed dramatically over recent years. Some of the changes include the introduction of the euro and the creation of the ECB, the broadening of the scope of policy coordination under the Lisbon umbrella, and the setting up of the Eurogroup. While having limited visibility, the significance of the Eurogroup as an essential part of the system of governance in EMU merits being underlined.

The Eurogroup is the key forum in which ministers, the Commission and the ECB jointly consider the economic situation and its policy aspects. Discussions in the Eurogroup help foster consensus with regard to economic prospects, risks, problems, options and policy orientations. While decisions are not within the remit of the group (being reserved for the Ecofin Council), the importance of the shared assessments emerging in the discussions should not be underestimated. The informal character of the Eurogroup is indeed an advantage in that it makes it possible to avoid cumbersome procedures and allows flexibility in deliberations. Ministers and the ECB are very well aware of the common interests at stake and of the need for coherence in communication and action (including on sensitive issues such as foreign exchange market interventions), notably in times of crisis or turbulence.

All in all, the economic policy regime in the EU is both complex and sophisticated. It is complex because it is based on a variety of methods including, *inter alia*, economic policy coordination within a Community framework, the creation of binding rules through Community legislation, and delegation of discretionary power to Community level bodies (such as the ECB). It is sophisticated because the various methods reflect the complexity of interdependence and the need to reconcile conflicting requirements on the policy process. While there is no obvious benchmark, the EU's multi-method system of economic governance may be deemed reasonably successful; it allows judicious interaction and balancing of national and Community dimensions with a view to surmounting difficulties and enhancing effective pursuit of the common interests of member states.

* * *

The requirement of unanimity among twenty-five or more member states is a big hurdle to changing the institutional structure of the EU. Even leaving enlargement aside, there is no agreed vision of the ultimate political objectives of the EU that could serve as a basis for a blueprint for radical reform. There is therefore little prospect for fundamental change to the system of economic governance in the EU. In fact, the issue was not even on the agenda in the recent IGC, apparently because there were few proponents of change.

This is no reason for regret if the system of governance is deemed basically sound and amenable to improvements through better implementation rather than requiring fundamental reform, as is the assessment of this book. The EU has a clear framework for microeconomic policies, the internal market, and for macroeconomic policies, EMU and its rules. The present multi-method system of economic governance combines reasonable robustness with considerable flexibility. There is no need in the EU or EMU for a big Community budget or an economic government to take supranational decisions. There is a good case for a system of governance based on a combination of Community legislation and rules as well as policy coordination and, in specific areas, delegation of power to Community bodies. Above all, responsible and effective action by member states will continue to be the key to success, in the member states as well as for Europe as a whole.

While the perception of the system of governance of the EU is often one of poor efficiency, heavy bureaucracy and weak accountability, the examination above does not suggest that it should be thrown overboard. The conclusions rather suggest that present arrangements have more of a rationale than is often realised or acknowledged. Mark Twain once made the following remarkable observation: ‘Say what you want about the music of Wagner, but you have to admit that it is actually much better than it sounds.’ Something similar may arguably be said about the system of economic governance of the EU.

Notes

1 Introduction

1 For a discussion of alternative attempts to define and legitimate the extent and nature of political authority, see Hampton (1997). The analysis in this chapter also draws on Mueller (1989).
2 The references to Hume (1739) and Smith (1776) are from Buchanan and Musgrave (1999).
3 See, e.g., Connolly and Munro (1999), Mueller (1989), Musgrave and Musgrave (1989) and Stiglitz (1988).
4 Asymmetric information refers to a situation in which one party to a transaction (usually the buyer) is less well-informed about the quality of the commodity than the other (usually the seller), because of difficulties of access to reliable information. Suppliers may then have weak incentives to invest sufficiently in quality (leading to adverse selection), and the market may not function satisfactorily. Public intervention may help by defining minimum standards or other requirements that producers need to satisfy. This perspective is relevant in, for instance, the areas of health care, unemployment insurance or pension systems.
5 See, e.g., Buchanan and Musgrave (1999) or Cullis and Jones (1987). The quotation is from Buchanan and Musgrave (1999: 18). The relation between efficiency and distribution has been a focal point in the public finance literature, at least since it was highlighted by Wicksell (1896).
6 The notion of the EU as a 'federation of nation states' is due to Jacques Delors; see Delors (2004), while the notions of the EU as a 'federative association' and as a 'Partially Federal Entity' are elaborated upon in Rosas (2004) and Piris (2003) respectively.
7 As used here, 'cooperation' is a generic term with wide scope: it may take the form of, *inter alia*, exchange of information and policy dialogue, discretionary coordination of policies and ageement on common rules and multilateral surveillance. In particular, it includes both 'intergovernmental cooperation' and 'common action', the latter term being a synonym for 'supranational action' (see Chapter 3). In EU discussions the term 'coordination' is mostly used in the same (vague) sense as 'cooperation'. It may also be noted that no distinction is made in the following between 'the EU' and 'the Community'.
8 See Monnet (1976) and Schuman (2000). The political motivation and character of the *démarche* is of course the main reason why the UK and a number of other countries at that time did not want to join the Community but rather opted for the less ambitious European Free Trade Area (EFTA).
9 The 'principle of conferred powers' is, in decisions by the Court of Justice (ECJ), balanced against another principle, which implies powers in favour

of the Community where they are necessary to serve legitimate ends pursued by it. For a discussion of 'the doctrine of implied powers', see Weiler (1999).

10 On these issues see, *inter alia*, Piris (2003) and Rosas (2004), Weiler (1999).

2 Rationale

1 Legal authors have often pointed to the analogy between the classical model of international law and the liberal theory of the state, where the individual in his relation to the state is the counterpart to the state in international relations; see Koskenniemi (1989) and Weiler (1999). For surveys of the literature on the idea of Europe as a framework for peace and order, see Mikkeli (1998), Salmon and Nicoll (1997), and Wilson and van der Dussen (1993).

2 See, e.g., Tabellini (2003) and Chapter 9.

3 On these matters, see CEPR (1995).

4 Such proposals have repeatedly been made by French socialists such as Jacques Delors, Dominique Strauss-Kahn and Pascal Lamy; see, e.g., Strauss-Kahn (2002).

3 Methods

1 For useful surveys of the theory of public choice, see Cullis and Jones (1987), Mueller (1989) and Persson and Tabellini (2000). This chapter draws notably on Mueller (1989).

2 The consideration of speed may justify a smaller fraction for passing a vote than simple majority. The extreme solution is to give dictatorial powers to one person in a command chain, as is the case in the army. However, in the context of voting it does not seem meaningful to consider fractions less than $^1/_2$, because simple majority is the smallest possible required majority to pass an issue while ensuring that the decision-making body does not risk self-contradiction (passing a particular decision but also its negation); see Mueller (1989: 55–7).

3 These axioms include the Pareto principle, non-dictatorship (no single voter's preferences always dominate), transitivity, unrestricted domain (no restrictions on voters' preferences) and independence of irrelevant alternatives (the collective choice between *x* and *y* should depend only on individual preferences between *x* and *y*, not on other alternatives).

4 The outcome could also be influenced by *strategic voting*. Assume that voting starts with *a* pitched against *b*, and that *B* now votes for *a* (though *B* would actually prefer *b*). This leads to *a* being pitched against *c* in the second round, and *a* winning again. This is better for *B* than if alternative *c* were to win (as would happen if *B* voted sincerely rather than strategically in the first round).

5 For the same reason, it is rational to aim at the minimum majority needed to pass the vote so as to maximise the gains of the majority; this is the 'minimum winning coalition hypothesis' put forward by Riker (1962).

6 It is also important to note that the unanimity requirement is no safeguard unless it is associated with respect for agreed rules. Otherwise, small states

in particular may find themselves being confronted with a stark choice between a bad deal (but one in which they are part of the deal) and an option in which big member states agree between themselves within an intergovernmental framework.

7 See Buchanan and Musgrave (1999: 26–7). A counter-argument is that transfers between member states are occasionally needed as side-payments for difficult agreements. Lump-sum intergovernmental transfers may be a better alternative as compared to inflating expenditure programmes to achieve the same redistribution. A possible reconciliation of the views is that Community expenditure should normally be governed by general principles while unspecified intergovernmental transfers should be resorted to only in exceptional circumstances.

8 This assumes that the Commission is firm and credible. Assume, for instance, that member states *A* and *B* were to propose a different solution and threaten to block the decision unless their demand were accepted. If the Commission deems that the threat is credible and is anxious to get a proposal accepted rather than none at all, it might abstain from using its right to veto an amendment proposed by the majority. Instead, if the Commission is known to stand firm, the majority might back down (as this would be better for all parties than the status quo).

4 Modalities

1 It may be noted that the 'founding fathers' envisaged that power would be vested with the Commission and (to a lesser extent) the European Parliament rather than with the Council, which was not even part of the original institutional design; see Westlake (1995).

2 See ECB (2004) and Issing *et al*. (2001).

3 Competence of national governments is largely general, while the Union can act only within the limits of the competences conferred upon it by the member states (the principle of conferral). Exclusive competence implies that only the Union may act, while member states can act only if empowered to do so by the Union. For shared competences, member states may exercise their competence to the extent that the Union does not. Also, competence may be restricted in the sense that decisions must comply with specific constraints.

4 These Treaty provisions have never been applied (which is not surprising given that cumbersome Community procedures cannot easily be reconciled with foreign exchange market realities). An informal practice has emerged, consistent with the above, according to which foreign exchange-market interventions are a matter for the ECB in conjunction with the Eurogroup.

5 For illuminating analysis of the Nice negotiations about weighting of votes in the Council, see Baldwin *et al*. (2001) as well as Galloway (2001).

6 It may also be noted that legislative power over implementing rules may be delegated to the Commission and is then exercised within a (complex) framework of *comitology*, involving advisory, regulatory and management committees with member state representatives.

5 Macroeconomic Policy in the SOE

1 For the original formulation and some elaborations and evaluations see Argy (1994), Dornbusch (1980), Fleming (1962), Krugman (1993), Mundell (1963), and Ugur (2002). For a survey of the literature on open economy macroeconomics, also covering the more recent 'new open economy macroeconomics', see Obstfeld (2001).
2 On the definition of targets for output and inflation, see Rogoff (1985). In Chapter 6 it will be assumed that the decision-makers are concerned not only about the budget position but also about the level of public debt.
3 The model was originally set out in Barro and Gordon (1983). For diagrammatic expositions of it see, e.g., de Grauwe (1997) or Hansen and Nielsen (1997).
4 This point is made in Rogoff (1985). It may easily be verified by noting that the sensitivity of output to the disturbance u is an increasing function of γ (the weight given to price stability).
5 This is the approach used by, e.g., Dornbusch (1976) and Krugman (1992).
6 Ricardian equivalence refers to the possibility that the effects of an expansionary fiscal policy are offset by increased private saving (reduced consumption) as households anticipate and prepare for the future tax increases needed to close the budget deficit. This could, *in extremis*, imply that fiscal policy has no effect on aggregate demand. It is more likely that the Ricardian equivalence implies a partial offset of fiscal policy. For an analysis of this issue, see Brunila (2002).
7 This assumption is by now conventional in open economy macroanalysis. Most models include some element of gradual adjustment on the 'real' side, and the exchange rate then jumps to the (unique) stable trajectory towards the new equilibrium (as the model in section 5.2). The model set out in Equation (5.A2), however, assumes instantaneous market clearing also on the goods market, which implies that shocks move the economy from one equilibrium to another without any gradual adjustment process.

6 Macroeconomic Policy in the EMU

1 This point has been made also by Hansen and Nielsen (1997).
2 The risk premia might of course differ between the countries rather than being uniform for the monetary union as a whole. For some considerations on this, see section 6.5.
3 See Hamada and Kawai (1997). For an extensive survey of the literature on fiscal and monetary policy coordination (which is 'voluminous and contains a variety of results'), see Andersen (2002).
4 The argument in favour of fiscal rules in EMU is that member states may run expansionary fiscal policies without fear of negative interest rate or exchange rate reactions. This contrasts with the case of the SOE at flexible exchange rates, for which financial market reactions act as a mechanism enhancing budget discipline. The fiscal rules in EMU may thus be seen as a substitute to compensate for the lack of financial market reactions (see section 6.5 below).

5 For an analysis of the interaction between monetary and fiscal policy in a monetary union, stressing their (strategic) substitutability, see Beetsma, Debrun and Klaassen (2001).
6 In effect, the *PP* curve in this case has a vertical segment at the level of $\bar{Y}$ between *E* and *A*.
7 See, e.g., Beetsma and Bovenberg (2001) and Italiener and Vanheukelen (1993).
8 The assumption of a quadratic loss function is convenient for the graphical exposition but not necessary for the argument.
9 Above, it was assumed that the risk premium depends on the structural budget deficit while it is here assumed to depend on public debt levels. This change of assumption is for convenience only; it could be assumed throughout that the risk premium is a function of both.
10 For some empirical evidence suggesting that fiscal policy in the euro-area countries has systematically been eased in election years or in the year preceding elections see Buti and Van den Noord (2003). On the factors giving rise to a bias towards high public spending and budget deficits, see also Calmfors (2003) and Fatas *et al.* (2003). One perspective on the SGP indeed stresses that it constitutes a useful counterweight to a political bias towards fiscal laxity (since it strengthens the hand of the finance minister against other members of the government) even if there were no cross-border externalities to justify action at the Community level. It is noteworthy that the SGP is more popular with pro-stability officials than with the academic community. On this point, see Willett (1999).
11 See Bayoumi, Goldstein and Woglom (1995).
12 See Chapter 4 above and Brunila, Buti and Franco (2001). This section will use the term SGP to cover the fiscal policy rules in general, without always making the distinction that the EDP is part of the treaty and not only of the pact.
13 See, e.g., Buiter, Corsetti and Roubini (1993), de Grauwe (1997) and Eichengreen (1997).
14 On 13 July 2004 the ECJ gave a 'Solomonic' ruling on the case: the Council was acting within its rights when refusing to adopt the recommendations put to it by the Commission, but the Council conclusions were annulled. In essence, the ruling states that the Council has discretion but the Commission the initiative.
15 For a survey, see Fatas *et al.* (2003).
16 The importance of the debt variable was downgraded when deciding on the initial membership of EMU (otherwise Belgium and Italy would not have qualified). The Council considered that the rate of decline in debt ratios in these countries was sufficient for the convergence criteria to be fulfilled.
17 See also Korkman (2001).

7 Structural Policies

1 It should be noted that structural policies in the sense used here have nothing to do with the use of structural funds as an instrument of economic and social cohesion policies, though the latter is often referred to as 'structural policy'.

2 For analysis of these issues and references to the literature see, for instance, Hansen and Nielsen (1997), Pelkmans (1997) or Swann (1995).
3 Well-developed financial markets act as a spur to growth by, *inter alia*, facilitating the creation of new businesses. They are thereby vital in helping the economy to adapt to changing circumstances. For an analysis underlining the strategic role of the financial system for the market economy, see Rajan and Zingales (2003).
4 See Lamfalussy *et al.* (2001).
5 The UK and the Nordic countries are mostly in favour of far-reaching liberalisation and integration so as to enhance competition and efficiency, while France and the southern countries tend to insist on investor protection and minimum rules to protect against a 'race to the bottom'. The former group of countries is typically in favour of mutual recognition and home country control, while the latter countries often want to ensure the possibility for the host country to impose obligations on all providers of financial services.
6 The Social Charter is a non-binding set of principles. It gets some legal teeth in the treaty following the IGC in 2004. The European Social Fund finances some education, training and job placement. The social dialogue involves governments and social partners at the EU level.

8 Tax Policy

1 For a discussion of the empirical trends in taxation in Europe, see Birch Sörensen (2001).
2 VAT registered traders must, in the present regime, report their tradeable sales (and VAT identification numbers) to registered traders in other member states in order to qualify for the zero VAT rate. These and other administrative requirements imply considerable costs; see Birch Sörensen (2001) and Verwaal and Cnossen (2001).
3 In particular, the negotiations on the CO^2-tax in the 1990s ended in deadlock. However, in October 2003 the Council adopted a directive defining a framework for the taxation of energy products and electricity.
4 Reinesch (1999) contains the review of a true insider of the tax debate before 1997.
5 The subsequent discussion, like much of the literature on international aspects of corporate taxation, focuses mainly on tax competition. There is, however, a kind of reverse phenomenon in the form of 'rent shifting': a high tax rate on corporate income may be attractive to the host country if much of the income accrues to foreign owners (provided that the location of corporate activity is not very sensitive to the tax rates). This would allow more of the tax burden to fall on foreign owners than on domestic residents.
6 Main achievements in this area include Directive 90/434/EEC on mergers, which provides for the deferral of taxation on cross-border reorganisation; Directive 90/435/EEC (parent/subsidiary directive), which eliminates double taxation on certain cross-border dividend payments; the Arbitration Convention 90/436/EEC, which provides for a procedure for the resolution of disputes in the area of transfer pricing; and Directive 2003/49/EC on interest and royalties, which abolishes double taxation for certain payments

between associated companies. The foundation of the more recent work is set out in Commission (2002).

7 Ireland was earlier applying a corporate tax rate of only 10 per cent to manufacturing industry and certain other activities while the general corporation tax rate was 28 per cent. Facing criticism within the code of conduct, Ireland decided to introduce a general corporate tax rate of 12.5 per cent from 2003. Also, there are territories that effectively have no business taxation at all, but these cannot be attacked under the code as long as zero taxation applies generally.

8 For presentations and critical examinations of the proposals see Birch Sörensen (2001), Commission (2002), Mintz (2002) and Weiner (2002).

9 The Community Budget

1 However, a distinction is made in the Community budget between 'commitment appropriations' and 'payment appropriations'. The former refer to financial commitments entered into during the year, irrespective of the timing of the actual expenditure (which may extend at least partly into future years), while the latter refer to the actual outlays during a particular year (partly reflecting commitments from earlier years).

2 See Tabellini (2003).

3 While acknowledging the recent and prospective reforms in favour of a shift from price support towards direct payments to farmers, the OECD makes the following sombre assessment of the agricultural policies of the Union: 'As a sizable share of subsidies is still linked to production, it benefits big farmers more and as it is accompanied by tariff barriers, it reduces imports also from poorer countries despite the fact that the European Union has abolished all import duties from the Least Developed Countries (LDCs) under the 'Everything But Arms Initiative'. Moreover, it traps resources in a low productivity sector, while consumers pay high prices for food. The price incentives under the existing system of production support also produce negative environmental effects'; see OECD (2003b: 103).

4 The McDougall report (1977) suggested roughly a five-fold increase in the Community budget.

10 Problems and Prospects

1 It may be noted that much of the weakness in the EU is accounted for by Germany. Output growth in Germany was on average 1.6 per cent in the years 1994–98 and only 1.2 per cent in 1999–2003. Reasons for the weakness in Germany include high taxes and social costs, rigid labour and product markets, the German reunification, low rates of return on capital (as a consequence of earlier over-investment reflecting artificially low capital costs owing to the central role of state-owned banks) and weak price-competitiveness (a too-high euro conversion-rate in 1999).

2 It should be added that recent figures suggest the earlier trend may have been reversed and that growth of labour productivity per hour is presently more rapid in the US than in the EU; on this, see Commission (2003b).

3 The price level is slightly lower in the EU than in the USA (in purchasing power standards). However, the US price level is to be seen as relatively low in the light of its high level of GDP per capita.
4 See, e.g., Frankel and Rose (2002) and Rose (2003).
5 The case of exchange rate policy is instructive. As noted in Chapter 4, exchange rate policy for the euro is a shared competence of the ECB and the Council, and Article 111 of the treaty foresees a variant of the Community method (without co-decision) to be applied. Not surprisingly, this has never happened and, most likely, never will.
6 The Lamfalussy method (see section 7.2) calls for more delegation to the Commission of power over legislation on implementing measures (within a so-called comitology procedure). The aim is to simplify and speed up procedures as well as to achieve more uniform implementation in member states. However, the advantages of delegation have to be balanced against the possible loss of 'ownership' of member states, which in itself is important for national transposition and implementation to be effective.
7 The negotiating position of the German Government was very strong at the time when the final decisions on stage 3 of EMU were taken, but Germany had to accept (if only after lengthy deliberations) that automatic sanctions would contradict the discretionary intentions of the treaty (Article 104 on the EDP).

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