Reflections on Europe's Economic Constitution

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The creation of European Monetary Union has transformed the framework for economic policy making. By establishing one budget constraint for all members, Euroland has effectively become a single economic unit. However, this implies that the structures of economic governance need to be adjusted to ensure that efficiency, stability and equity prevail in Euroland's economy. Although this requires different forms of policy coordination, none of theses economic values are sustainable in the long run unless policy making is backed by full democratic legitimacy. In this paper, I will first look at the experience with policy coordination since the start of EMU, then deal with theoretical questions, and finally address the issue of Europe's democratic deficit.

1. The need for economic policy coordination

It is the essence of a monetary market economy that money serves as the budget constraint on the many individual spending plans because it is scarce relative to other resources. Therefore maintaining the value of money as a liquid reserve asset is an essential precondition for any monetary economy to function correctly. Different markets for goods, services and factors are integrated by the payment system. Through this mechanism inconsistent choices in one market spill into other markets (Walras' Law). An efficient and sustainable monetary economy requires that the decisions in different markets are consistent with price stability and the improvement of general welfare. Otherwise an economic system is threatened by disintegration. For this reason, the success of the European monetary union requires the completion of the single market for products and services, but also for capital and labour. However, inconsistent preference realisations in different markets can destabilise the system and lead to durable losses of welfare. This is particularly true, first of all, in the capital market where excess demand for funds by public borrowers can crowd out private borrowing and investment or push interest rates up.[1] Secondly, if nominal wage bargaining is inconsistent with price stability, the central bank has to raise interest rates in order to fight inflation. Hence, both fiscal and income policies can have significant impact on welfare realisations. Reducing possible inconsistencies increases the economy's efficiency and stability. At the same time, consistent preferences are more easily accepted as equitable.

A consistent set of policy preferences between different economic actors is called an efficient policy mix.[2] The question is, how such an efficient policy mix can be achieved, while the economic constitution of Euroland is based on the very unequal balance of power between policy makers. The European Central Bank (ECB) alone sets short term interest rates as a fully independent institution. Fiscal policy remains under the authority of national governments, but the coherence of their objectives is presently dependent on the compliance with the Stability and Growth Pact. Finally, wage bargaining is largely on firm or national sectoral levels. It is uncertain to what degree this allows consistency with the objective of

[1] By excess demand for funds I mean that Ricardian Equivalence does not hold, i.e. an increase in government borrowing does not lead to an increase in private savings of equal proportions.
[2] The European Commisssion calls it a "harmonious" policy mix.

price stability in Europe.[3] The *Macroeconomic Dialog* is an instrument of "open" policy coordination to improve the flow of information between decision makers. However, in principle, there is a large range of efficient policy mixes possible. An *optimal* policy mix chooses a specific combination of policy stances that maximises a given social welfare function.

1.1 Definition of an optimal policy mix

Traditionally, the concept of policy mix is related to the idea of the so-called magic quartet whereby economic policy should simultaneously try to achieve price stability, full employment, sustainable growth and external balance. Tinbergen had developed a framework for this analysis in the 1950s where one policy instrument corresponded to each target. Monetary policy was aimed at price stability, wage policies at employment, fiscal policy at growth and the exchange rate at external equilibrium. This analysis implicitly assumes that there are no interdependencies or spillovers between these different policies. However, reality is not that easy. Interest rates also affect fiscal policy through the debt service and economic growth and both have impact on unemployment. The early theories about policy regimes were also unaware of the Lucas-critique whereby private actors respond to policy regime changes and therefore change the structure of the economy within which policy actions are supposed to have their intended effects.

A modern way of looking at an optimal policy mix would still try to achieve simultaneously internal and external balance but would have to take into consideration the interdependencies between the different policy areas and their reactions by rational private actors. Internal balance requires price stability and full employment, while external balance should reflect a current account position that is in line with sustainable foreign debt and domestic growth considerations. Although price stability is ultimately the objective for monetary policy, it needs to be supported by stable unit labour cost and therefore by wage bargaining that focuses mainly on the distribution of productivity gains. If unit labour costs are kept stable, monetary policy can be more accommodative for economic growth, lowering interest rates and thereby supporting the creation of employment. Modern economic theory also emphasizes that fiscal policy in the long run should aim at keeping public debt sustainable. This does not mean zero deficits or balanced budgets, but simply a stationary debt/GDP ratio. Hence, the debt service must be covered by an adequate primary surplus. This means that in the medium and long run Ricardian equivalence holds whereby savers are aware that government borrowing will be repaid by future tax levies. However, in the short run automatic stabilizers can play an important role in stabilizing effective demand in case of temporary demand shocks.

1.2 Where do we stand?

During the first two years, Euroland has been lucky. Inflation remained below 2 %, interest rates were rather low and economic growth and employment started to increase. Budget deficits were falling. These positive developments clearly reflect some of the structural

[3] For a discussion, see C Crouch (2000): National Wage Determination and European Monetary Union: in C Crouch (ed): After the Euro. Shaping Institutions for Governance in the Wage of European Monetary Union ; OUP, Oxford; O. Sievert (1993) : Geld das man nicht selbst herstellen kann – Ein ordnungpolitisches Plädoyer für die Europäische Währungsunion ; in : P. Bofinger, S. Collignon, E.M. Lipp (1993): Währungsunion oder Währungschaos? Was kommt nach der D-Mark? Gabler Verlag, Wiesbaden.

advantages from creating a single currency. Those who fought for European Monetary Union had always expected them.

However, in the later part of 2000, Euroland has been affected by two supply shocks: the increase in the oil price and food prices. These supply shocks have lowered potential output, at least temporarily. As the experience of the 1970's shows, such shocks require a lowering of effective demand in order to avoid inflationary pressures. From that point of view, a tightening in effective demand in the short term would have been justified and this should have been achieved by tighter monetary policies i.e. higher interest rates or by fiscal policy. But higher interest rates also lower incentives to invest and therefore reduce the growth of potential output. On the other hand, if fiscal policy were not tightened, the public sector would crowd out the private sector. Therefore, from a point of view of creating growth and employment, the appropriate response to the shocks of 2000 would have been a coordinated tightening of fiscal policy so that monetary policy could have remained more accommodative. In fact, the opposite happened. Monetary policy tightened considerably in the latter part of 2000, while the fiscal policy stance did not change (the cyclically-adjusted primary balance did not move significantly).[4]

It could be argued that the negative supply shock from oil and food prices could have been compensated by a positive supply shock of lowering wages. However, price stability requires over the medium term that unit labour costs also remain stable. If a negative supply shock has lowered productivity, this would imply that nominal wages would have to fall. Yet, this is hardly acceptable to the wage earning population in Europe because households have contractual obligations that need to be serviced in nominal terms. Alternatively, it could be argued that by keeping wages nominally stable, but allowing prices to rise due to higher oil and food prices, real wages would fall and this would compensate for the negative supply shock. Yet, this could put additional strain on the credibility of the European Central Bank as there is a danger for price increases to be recuperated by wage earners compensating for the loss of purchasing power. It therefore seems to me that income policies would not have contributed significantly to economic growth and a modest tightening in fiscal policy would have been the right answer, although one would have had to be careful not to inhibit the automatic stabilizers.

In late 2001 the two supply shocks have been dominated by two further shocks; first the US-slowdown and then the 11-9 crisis. These shocks reduced aggregate demand significantly, largely because the heightened uncertainty reduced investment, trade and consumption sharply. Under these circumstances the appropriate response would have been fiscal expansionism in order to re-establish confidence and stimulate demand. At minimum, fiscal policy should have kept the cyclically adjusted structural budget position in Euroland stable, but allowed automatic stabilizers to work fully. Yet, rigid interpretation of the Stability and Growth Pact seems to force major countries like Germany into a pro-cyclical budget consolidation.

What this discussion shows is how difficult it is and how careful one has to be in order to assess the right policy stance in the short run to optimise the policy mix. In fact, optimal fine-tuning may well be unachievable. However, even if not every shoot hits the bull's eye, it is important to know where the target is. The described difficulties are greatly increased by the uncoordinated nature of fiscal policy in Europe. I will come back to this point below. Here I

[4] See European Commission, 2001 : European Economy, Public Finances in EMU ; No 3, 2001.

would simply insist that progress comes from walking on two legs. The appropriate response to *supply shocks* are structural reforms aimed at higher potential output in Europe. Focus must be on completing the single market, especially for goods, services and capital markets and to rapidly implement the reforms decided at Lisbon. Creating a competitive European knowledge society and placing it in the context of sustainability as in Stockholm reflects the European approach to overcome our structural impediments and increase our output and growth potential. However, all these measures ultimately need public and private investment and this requires a monetary environment of stability and low interest rates. Therefore appropriate demand management, usually called stabilisation policies, have to complement the structural reforms.

2. Policy coordination and preferences

Given the single budget constraint, an optimal policy mix needs to be determined for the whole of the euro area and not only in the national context. This means not only achieving an efficient policy mix where aggregate supply and demand are in balance, but also a determination of collective policy preferences. Therefore, the degree of policy co-ordination between different jurisdictions within the unified Euroland economy must be significantly higher than between countries which are linked by exchange rates.

2.1. What kind of policy co-ordination?

Is economic policy co-ordination actually needed? Economic theory in the 1980s has discussed this question mainly from a point of view of exchange rate regimes. In the context of European Monetary Union, these theoretical approaches are no longer adequate and increasingly economists are using the theory of clubs and public goods as their reference model. These models start with the premise that in a monetary union there are certain goods, which are shared by all. Examples are the price level, the exchange rate, interest rates, the current account balance etc. These variables are called *club goods*. The existence of EMU club goods implies a new channel of externalities between national economic policies. Policies of individual member states that affect relevant European aggregates have economic implications for other member states because the ECB will react to them and this reaction is felt by all other member states as well. Consequently, it is not enough to look at the direct transmission of policy impulses between countries to identify the need for co-operative policies in the euro area[5].

The economic literature on collective goods or club goods has clearly established that the uncoordinated provision of such goods can lead to sub-optimal supply. This is called co-ordination failure. The *theory of co-ordination failure* allows us to distinguish between different forms of co-ordination. We will focus on three cases.

1. No policy co-ordination is required if the externalities can be *privatised*. In this case, markets can price the impact of the externality and this will provide the optimal supply of these goods. A typical example in Europe is the *no-bail-out* clause for public debt, where private capital markets are supposed to price the risk of default when public authorities over-indebt.

[5] See Jürgen von Hagen and Susanne Mundschenk, *The functioning of economic policy co-ordination*, ZEI University of Bonn, May 2001

2. Inter-governmental co-operation is appropriate when club-goods are *inclusive*. This means there are strategic complementarities between the objectives of different policy makers. These complementarities arise when the objectives of all other players induce a change in the same direction by any national government because any national government benefits from the fact that the aggregate supply of this club good is higher. Such club goods are called inclusive because the benefit for some members, but not necessarily for all, is sufficient to ensure the provision of the good – although supply may not be optimal. Typical examples for such inclusive goods are the policy objectives established in Lisbon. For example, the development of a "knowledge society" does not necessarily require the participation of all. If a sufficiently large number of governments and agents participates they thereby create a dynamic that lowers costs for members and might lead others to follow this example. But clearly, if all countries implemented the necessary reforms, welfare would be optimised. Similarly, wage bargaining can be seen as an inclusive club good where the wage developments in Germany are setting a bench mark that other wage bargainers seem to consider for their own bargains. However individual bargains may deviate from the norm and lead to regional unemployment. The theory of co-ordination failure shows that inclusive public goods create *strong co-ordination failure* meaning that only *ex ante* co-ordination may ensure sufficient investment to provide them. Usually, there are multiple equilibria possible which are not optimal. Usually, this failure can be overcome by improved communication, which would help actors to understand the motives of the other club members and therefore improve the provision of such goods. European policy co-ordination typically has used these devices in the creation of the single market by setting common standards or by setting up the Euro-group. The underlying logic of the Macroeconomic Dialogue is also derived from the assumption that wage rigidities in the labour market lead to sub-optimal employment equilibria, which can be improved by communication between wage bargainers and policy makers.

3. If club goods are *exclusive*, all members of the club are required to participate in their provision. This means - contrary to inclusive public goods - no free riding or opt-out is admissible. Exclusive club goods are subject to *weak co-ordination failure* which is much more serious to remedy because it requires binding constraints and community institutions for rule setting and policy-making. A typical example is monetary policy: the binding budget constraint for a monetary economy requires that all member states have the same interest rate and this could only be provided by establishing a European Central Bank as the sole policy maker. Most club goods resulting from EMU are effectively exclusive. The argument also applies to the definition of an *aggregate fiscal policy stance.* For example, starting from macroeconomic equilibrium, assume that an EMU member state adopts a tax policy that leads to a slowdown in economic growth and an increase in prices in this country. As a result, the euro area price level moves upwards. The ECB might react to this change with an increase in interest rates, thereby affecting the macroeconomic equilibria in all other EMU states. Thus preserving the quality of the EMU club good called "price stability" in the presence of uncoordinated national policy actions by member states creates economic costs for all other members. This problem can only be overcome by the definition of an aggregate fiscal policy stance that is relevant for monetary policy of the ECB. Such an aggregate fiscal policy stance is an exclusive club good because every member state has to contribute. As a consequence, an institution is needed to define such a policy stance.

We can now summarise these reflections. The optimal supply of public goods requires policy coordination. But different public goods do not demand identical regimes of management and decision making competences. Inclusive public goods can be efficiently provided by the "open method of coordination", i.e. essentially by intergovernmental cooperation. Exclusive public goods are only supplied optimally when every member of the club is fully committed to its creation – without breach of compliance. This requires a high degree of obligation and is best achieved by delegating responsibilities to a common institution. Hence, the criterion for a (re-)distribution of tasks, responsibilities and competence, in the European Union should be the nature of public goods and externalities. However, this raises the question, how policy decisions on the European level are given legitimacy.

2.2. Policy preference formation in the EU

In a modern democratic state, collective choices reflect the preferences of the "people". These preferences are formed on the background of shared values, common knowledge but also rational debates and communicative action. The definition of optimal European policies will then require the formation of European public preferences. Today policy preferences are determined nearly exclusively within a national framework, although they are subsequently traded off in multilevel intergovernmental bargaining. For example, budgets are set by national parliaments and this is the ground rule of democracy ("no taxation without representation"). National parliaments reflect national preferences and these preferences are formed through democratic debates *in these countries*, often during parliamentary debates or electoral campaigns. The definition of European policies cannot be superimposed at the European level without seriously undermining the national legitimacy of policy decisions. The Irish referendum is an indication for the growing democratic deficit that follows from intergovernmental policy co-ordination around exclusive club goods in Euroland. Not surprisingly, this vote came soon after the Community tried to impose a critical "policy recommendation" onto the Irish government. In fact, the Stability and Growth Pact (SGP) is exactly an example for the violation of national legitimacy that could endanger compliance in the long run. The SGP sets a simple policy rule: all national budgets should be balanced over the business cycle and excessive debt/GDP ratios require additional surpluses in order to bring them down below the 60% margin. This rule gives the clear indication what fiscal policy stance is to be achieved nationally and in aggregate. It leaves it to the European Central Bank to set interest rates at the level, which ensures aggregate demand to be in balance with potential output. However, this rule is not really consistent with the statement by the European Commission whereby "economic policy co-ordination within the euro area is based on consensus. It does not aim to impose decisions on a particular member state".[6] For the question arises whether the simple policy rule of the Stability and Growth Pact is always optimal in the sense of reflecting collective preferences. The pact does not provide any flexibility in changing policy priorities. Yet, there can be cases when the balanced budget rule is not appropriate, either because an optimal policy mix would require further lowering of interest rates and therefore higher budget surpluses or because the authorities wish to follow a *golden rule* where public investment is financed by debt. In periods when the economic growth rate is higher than the real interest rate, it may even be possible to sustain durable deficits and simultaneously run down the debt/GDP-ratio. In fact, the aggregate fiscal policy stance should be a matter of collective preferences. It must reflect the time preferences for intergenerational tax burdens. Hence, an optimal policy mix depends on what preferences people in Europe have and how these preferences are formed.

The problem is not so much at the level of inclusive public goods where intergovernmental cooperation may achieve acceptable results. It is at the level of community policies where European institutions will only be capable to act if their legitimacy in policy making is

[6] Commission of the European Communities (2001): *Commission Communication on strengthening economic policy co-ordination within the euro area*. Brussels, 7.2.2001. COM (2001) 82 Final.

improved. Neofunctionalist integrationist theory has insisted that European unification will result from institutional spillovers. This dynamic seems validated by the process, which led from the customs union to the single market with a single currency. However, the theory is lopsided because it is exclusively focussing on the extension of community tasks. What is absent is the consideration that policy makers need legitimacy as their input resource. The growing "democratic deficit" is therefore undermining the integration process.

Policy decision about European public goods need to reflect collective preferences on the European, not national level. Given the compactness of European life-worlds (Habermas), i.e. long established traditions and cultures that form the background for decision making, these European preferences do not arise "naturally". But intergovernmental bargaining does not permit the emergence of collective choices through the process of democratic participation, because European choices are made behind closed doors in ministerial councils. The European policy style has more to do with paternal and hierarchical-holistic societies than with modern liberalism where citizens own the public space. European collective preferences need to be "constructed" by democratic policy deliberations and public debates, which allow the optimizing of information sets and the potential participation of every citizen in Europe. The creation of a European public space is an essential principle of democratic societies that "every citizen has one vote and all representatives have equal rights".[7] Therefore, the Stability and Growth Pact will not be sustainable in face of the growing democratic deficit in Europe, although it may be a short-term solution for defining an optimal policy mix. What is needed in the long run is a fully democratically legitimated policy mechanism for the definition of policies with respect to exclusive public goods.

3. Legitimacy of policy-making

3.1 The general framework

The current system of intergovernmental cooperation is characterised by an increasing lack of democracy. The governments of the member *states* of the EU take more and more political decisions, even though the European Commission has the right to propose policies in some areas and the European Parliament must "co-decide" in 25 percent of all Community legislation. Intergovernmental cooperation means, however, that political decisions become solutions negotiated by autonomous agents and not, as is usual in democratic states, the expression of collective preferences regarding public goods. In other words, the individual European citizens remain "*subjects*" of their states, not "*principals*" of the collective agency, as modern liberalism would postulate. Furthermore, the complexity of such intergovernmental negotiations will grow dramatically with the number of member states. As long as national vetoes are possible, the danger of political paralysis in the EU continues to grow.

At the European Council meeting in Nice at the end of 2000, an attempt was made to prepare the EU for enlargement; but the highly complex decision-making model of triply qualified majorities will by no means strengthen the European capacity for decision-making. Applying game theory to the various models of qualified majority decision-making, F. Bobay found that in an EU with 27 member countries, the model adopted at Nice is "the system with the weakest capacity to promote collective decision-making."[8] Decisions require so-called

[7] Ch. Lord and D.Beetham (2001): Legitimising the EU: Is there a "Post-parlimentary Basis" for legitimation?, in: Journal of Common Market Studies, Vol. 39, No. 3, p443-62.
[8] Frédéric Bobay, 2001, Emergence d'un nouvel équilibre européen à Nice; mimeo

winning coalitions to produce the necessary qualified majority. Based on the modalities approved in Nice, winning coalitions can be formed in only 2.0 percent of all cases in an EU with 27 member states. With the pre-Nice system, this figure would increase marginally to 2.4 percent. The proposal of a system of double majorities (the majority of countries and the majority of the population) suggested by the Commission prior to the Nice summit would have resulted in winning coalitions in at least 35.7 percent of all cases.

The difficulty of finding efficient decision-making structures in Nice reflects a basic dilemma of European integration: states are the central and legitimate agents, but their existence prevents the emergence of a European principal. If such European principal would exist, states would lose their legitimacy as agents of the people.[9] Yet, this conflict does have a solution, if one concentrates on the task of administering public goods efficiently. European public goods require European agency, national public goods require national agency. The central question is then rephrased as "which public goods are European, and which are national or regional in nature?" From our definition of public goods above, one can deduce clear criteria for the allocation of competencies among the different levels of political action.

The central criterion must remain the *principle of political congruency of action*, i.e., the congruency between the range of the problem to be solved and a corresponding reach at the political level capable of fulfilling this task.[10] This depends on the nature of public goods. Clearly, the allocation of regionally limited public goods with few externalities beyond jurisdictions, such as schools, hospitals, and roads is most efficiently done at the regional/national level. Equally clearly, other functions of public action create important externalities and therefore have a European dimension, although one must distinguish between *inclusive* and *exclusive* public goods. As we have seen above, inclusive public goods can be provided efficiently by intergovernmental policy coordination. Hence, only *exclusive public goods require the delegation of power to the European level*. But such delegation needs the creation of a European principal in order to give full legitimacy to the public choices made by the European agency. This must be the content of a European Constitution.

3.2 Choosing an optimal policy mix

With respect to economic policies, we have seen that EMU has created many new club goods, which resemble exclusive public goods. Hence, the efficient conduct of economic policy in EMU requires further delegation of stabilisation policies and possibly also some redistribution functions to the European level. The theory of fiscal federalism has provided the theoretical justification for this option a long time ago. The Werner Plan in 1970 was also clear about this need, although the Delors Report in 1989 avoided the issue and the SGP subsequently tried to mend the gap.

I see two possible strategies to proceed at this point. *Fiscal federalism* would recommend a larger EU-budget with the purpose of centralising public spending. This would eventually imply that the Commission proposes the budget and has revenue-raising authorities. It would have to be legitimised by the European parliament, possibly in codetermination with the Council. Alternatively, one could envisage a future institutional set-up which I will call the "Envelope approach". The Commission would determine the appropriate aggregate fiscal

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[9] We could also say that in today's system, *states are the principal* of the European Union, rather than private citizens, as modern political philosophy would recommend. However, this implies that states are both, principal and agent for European policy. This is a rather Byzantine idea of democracy.
[10] T. Fischer and N. Schley (2000): Europa föderal organisieren; Bertelsmann Stiftung; mimeo

policy stance, reflecting European citizens' public preferences, which yield the optimal policy mix. This has to be done by the Commission, because it is the only institution that has the required know-how, services and information to formulate coherent policy options for the aggregate. It cannot be done by a *gouvernement économique* consisting of national state bureaucracies. A European administration would set an "envelope" for the aggregate public expenditure and income and therefore define also the aggregate deficit. The proposed aggregate fiscal policy stance would then have to be approved in a second step jointly by the European Parliament, reflecting the democratic choices of the European principal and the Council, assuring the coherence between the aggregate policy stance and the national policy implementations. In the final stage national governments would set their national budget priorities within the framework of the overall envelope. This guarantees that national priorities remain fully coherent with the requirements of a properly functioning monetary economy in Euroland.[11] In order to strengthen the commitment by national governments to stick to the agreed overall budget envelope it may be necessary to think about the setting up of a stabilization fund or a system of limited national transfers.

An arrangement along either of these lines would mean that the economic governance of Euroland would need to be contained in the constitutional arrangements of the European Convention. In fact, what is necessary is not only to redefine the tasks vertically in terms of responsibilities between different jurisdictional authorities, but also horizontally in terms of the disentanglement between the executive functions and the legitimising and legislating functions of government. The concept of collective club goods and their inclusive and exclusive nature provides a criterion for the vertical redefinition of tasks. However, it should be clear that a proper policy making at the European level also requires greater democratic legitimacy in the formation of collective preferences than can be provided by national governments and institutions. The need for defining European citizens as the principal does not imply the creation of a European super-state; but it means that Europe's public goods have effectively become a *res publica europea*. Unless policy makers and the European Convention address this issue over the next few years, Europe may well disintegrate again. The choice is between a European Republic or the United Nations of Europe.

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[11] This suggestion is in accordance with some established budget procedures. For example, in the French V[th] Republic, *l'Assemblée nationale* first votes the macroeconomic framework and then proceeds to the *arbitrage* of political priorities.