The Lisbon Strategy, Macroeconomic Stability and the Dilemma of Governance With Governments

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Abstract. This paper argues that Europe's economic reforms fail because of collective action problems. The Lisbon strategy requires more than supply side reforms managed by "governance without government." They must be imbedded in a coherent macroeconomic stabilisation policy. As one can learn from the American example, successful demand management makes a difference. The reformed Stability and Growth Pact is not capable of providing an optimal policy mix. What is needed is a proper government for the European Union, or at least Euroland. However, more delegation to the European level is only legitimate if European citizens can exert their democratic rights.

At the Lisbon European Council in March 2000, the heads of State and government promised to make the EU by 2010 "the most dynamic and competitive knowledge-based economy in the world, capable of sustainable economic growth with more and better jobs and greater social cohesion, and respect for the environment." If this statement was meant to inspire enthusiasm, it has failed. By over-committing and promising unachievable goals it has ridiculed European policy making. Despite desirable objectives, compliance with the strategy agreed in Lisbon has been insufficient to produce the desired results. According to the European Commission (2005:4) this is due to "a policy agenda, which has become overloaded, failing coordination and sometimes conflicting priorities." The reasons for this coordination failure are not well understood. Governments are exhorted "to do more reforms", but few seem capable to implement them and when they do so, the results are not as expected.

Five years after Lisbon, midway to the goal, the European Commission called for a new departure in spring 2005 by focusing on a limited number of "key actions that promise the highest and most immediate dividends" (Barroso, 2005), namely investment,

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innovation and jobs. However, as much as one should welcome this sharper focus, there are two noticeable holes in the "new" strategy: macroeconomic policy and the issue of governance. The "new" Lisbon strategy is therefore "less, but the same." It is less, because macroeconomic management and social cohesion have been dropped from the agenda; it is the same because it does not address Europe's institutional problems. Especially after the failed ratification of the Constitutional Treaty in France and the Netherlands, institutional reform has become a taboo. I will show that the EU's disappointing performance cannot be separated from macroecconomic management and ultimately from constitutional questions. The issue is less of "governing without government" (Rosenau, 1992; Rhodes, 1996), and more a problem of "governance with governments." I will first examine what Lisbon is about, and then what needs to be done to improve it.

What the Lisbon Strategy is all about?

The background

The Lisbon strategy was inspired by the strong economic growth in the United States during the Clinton years and the perceived incapacity of Europe to do the same. The US economy had reached the longest lasting upswing in its history in the late 1990s, as the government had stabilized public spending and cooperated closely with the central bank to bring interest rates down. As a result, the investment share rose in the USA from 16 percent in 1992 to 21 percent in 2000 and unemployment fell to 4 percent, the lowest level since the 1960s. New investment incorporated technological innovation in ITC industries and raised productivity after a long period of stagnation. This was the envied model of America's "new economy."

By contrast in Europe, unemployment was high, investment and growth low and the sense of stagnation all-pervasive. The investment share, which stood at 27 percent in the 1960s and early 1970s, fell from 22 percent in 1991 to 20 percent in 1996, but the investment did not incorporate technological progress to the same degree as in the USA. Human capital also seemed to be deficient. While the US economy was deregulated in

the 1980's, *eurosclerosis* was assumed to be related the insufficient integration of markets and policies in the EU. Thus, active supply side policy were considered necessary to close the transatlantic gap. During the 1990s a number of "processes" had been set up by different European Councils to remedy this. The Luxembourg process for labour market reforms was agreed in 1997. Procedures for the complete unification of the goods and capital market were put into place in Cardiff in 1998. Finally at the 1999 Cologne Council meeting, a macroeconomic dialogue between wage bargainers, finance ministers and the European Central Bank (ECB) was set up to support a better policy mix. These "processes" did not produce the expected results. After all, the reason for calling them a process was that the European heads of State and government could not agree on the substance of policies. They were constrained by their national debates and the partial interests of their home constituencies. But there was hope that through *processes* of common policy deliberation, governments would ultimately find *solutions* acceptable to all. However, compromise usually meant the lowest common denominator, not policies optimising welfare. Europe's economic governance had become a mix of cheap talk on reforms and gridlock in decision-making.

The Lisbon strategy was an attempt to overcome these difficulties. No longer a "process", it was meant to load substance into the empty lorries of Cardiff, Luxembourg and Cologne. In the version finally agreed, the strategy addressed four policy *areas*: (1) Reforms to create a knowledge society, intended to help Europe catching up with the "new economy" and improve productivity. (2) Optimal macroeconomic policies to ensure that the higher potential output would effectively be absorbed by demand in product markets without creating inflationary tensions. (3) Completing the integration of Europe's capital market to increase investment, especially by raising venture capital for innovation in small and medium-sized companies. (4) Reformulating the European social model, not by dismantling the welfare state, but by putting social inclusion first and empowering governments to deal with the challenges of globalisation and an aging society.

The Lisbon agenda *reflected* the dominance of centre-left governments in Europe at the time. Portugal's Prime Minister Antonio Guterres had first designed the basic objectives in a working group of the European Socialist Party (ESP) in 1999. The Lisbon strategy was conceived as a two-pronged approach of supply-side reforms matched by responsible demand management. Increasing welfare necessitated higher productivity and therefore innovation and knowledge to improve potential output. But new jobs are only created when GDP grows faster than productivity. Therefore macroeconomic policy was indispensable for creating jobs, and also for consolidating public finances and releasing resources for Europe's social model. Previously, the European Commission had calculated that with 3 percent growth the EU would reach full employment within a decade. In 1999, the German presidency therefore set up the Cologne process, aimed at a growth supportive macroeconomic environment with low interest rates.[2]

A year later, the Portuguese presidency sought to re-enforce this growth strategy. In preparation for the Lisbon Council meeting, there was discussion among member state governments about setting a 3 percent growth rate as a numerical policy target. Given that the European Central Bank (ECB) has defined price stability as a rate of inflation "below, but close to 2, it seems reasonable that the European Council could also set its growth target numerically. After all, while the ECB certainly had price stability as its "primary objective" (art. 105.2 of the Treaty on European Union), it was also obliged, according to art. 2 of the Treaty on European Union, "to promote throughout the Community a harmonious, balanced and sustainable development of economic activities, a high level of employment and of social protection, equality between men and women, sustainable and non-inflationary growth, a high degree of competitiveness and convergence of economic performance,(…)", once price stability was assured. Therefore, specifying the numerical content of this Treaty article, would have been a step toward rebalancing the policy mix. It was meant to strengthen the voice of Finance ministers in the informal meetings of the Euro-group in those years, where the central bank had taken a hard line on "independence", bordering on uncooperativeness.

[2] At the time, the author was an active participant in the Guterres ESP-group and in charge of inter-ministerial policy coordination in the German government. For the theoretical foundation of the macroeconomic strategy behind the Cologne process and Lisbon strategy, see Collignon 1999.

Furthermore with growth at 3 and inflation at 2 percent, and with budget deficits capped at 3 percent, the debt/GDP ratio would have stabilised below 60 percent, ensuring the long run sustainability of public finance. A growth target of 3 percent would therefore also have helped fiscal consolidation. But in the end the option of fixing a numerical growth target was not adopted when at the Lisbon Council a member from an opt-out country insisted that more ambitious objectives would unleash entrepreneurial creativity. Hence, the 3 percent target was replaced by the goal of becoming "the world's most competitive economy." This formulation effectively prevented the institutional anchoring of macroeconomic policy into the Lisbon strategy. As right wing governments subsequently swept into power, the emphasis on macroeconomic policy and social inclusion was lost. Was re-interpreted as a neoliberal agenda and never really took off.

Public goods and the "open method of coordination"

When preparing the Lisbon summit, the Portuguese presidency of the European Union quickly faced the dilemma of previous initiatives: why would national governments agree to European policies that might constrain their actions at home? The optimistic and somewhat naïve answer by European policy makers has always been that there existed positive policy externalities, which created incentives to cooperate. The Kok-report (2004) formulated it neatly: "Actions by any one Member State (…) would be all the more effective if all other Member States acted in concert; a jointly created economic tide would be even more powerful in its capacity to lift every European boat. The more the EU could develop its knowledge and market opening initiatives in tandem, the stronger and more competitive each Member State's economy would be." Along these lines, the European Commission has also been propagating for years that "massive potential gains" were to be reaped from wider and deeper integration, while "non-Europe" was a costly waste of resources. But the question remains, why these gains are not realised despite such obvious advantages for all.

The answer is not simply lack of focus or insufficient support, as the Commission (2005:5) claims. It is founded in the structural nature of incentives for political action. Political scientists know from the theory of collective action that the existence of

potential positive spillover effects is not enough to ensure cooperative behaviour (Olson, 1971). If the costs and benefits of actions are not properly matched for individual actors, cooperation failure is the result. This phenomenon can be described by the opposite incentives for two different types of public goods: inclusive and exclusive public goods.

Inclusive public goods, sometimes also called club goods, are characterised by positive externalities as more members participate in a group. Because one can impose restrictions on access to the club, every individual will make efforts to contribute to the realisation of these benefits. Thus, inclusive goods provide incentives for successful voluntary cooperation between independent utility maximising actors. It is of course possible that asymmetric information could lock partners into suboptimal equilibria (prisoner dilemma). But the existence of the European Commission acting as an impartial coach should ensure that these obstacles are overcome and everyone knows what action is required. Thus, the nature of the externalities provides the "regulatory mechanism" by which exclusive public goods are provided without formal and central authority. Such a policy regime has been called "governance without government" (Rosenau, 1992; Rhodes, 1996).

European integration provides a number of examples for such inclusive public goods. Successful political cooperation has taken place in network projects like the Galileo satellite navigation system or the Airbus project, where the benefits of cooperation are high and the possibility of reaping them is clearly allocated to each contributing participant. Also, a typical club good phenomenon is participation in European monetary union (EMU), which induced the coordination of macroeconomic policies. The Maastricht criteria helped create low inflation, because (nearly) everyone wanted to share in the benefits from monetary union and the possibility of being excluded made governments comply. Convergence policies were therefore "owned" by member states. The role of the Commission consisted in monitoring the process and overcoming information asymmetries to prevent blockages. Hence, the logic of inclusive public goods makes successful voluntary cooperation among governments possible, provided formal procedures facilitate the flow of information. With the successful convergence to the

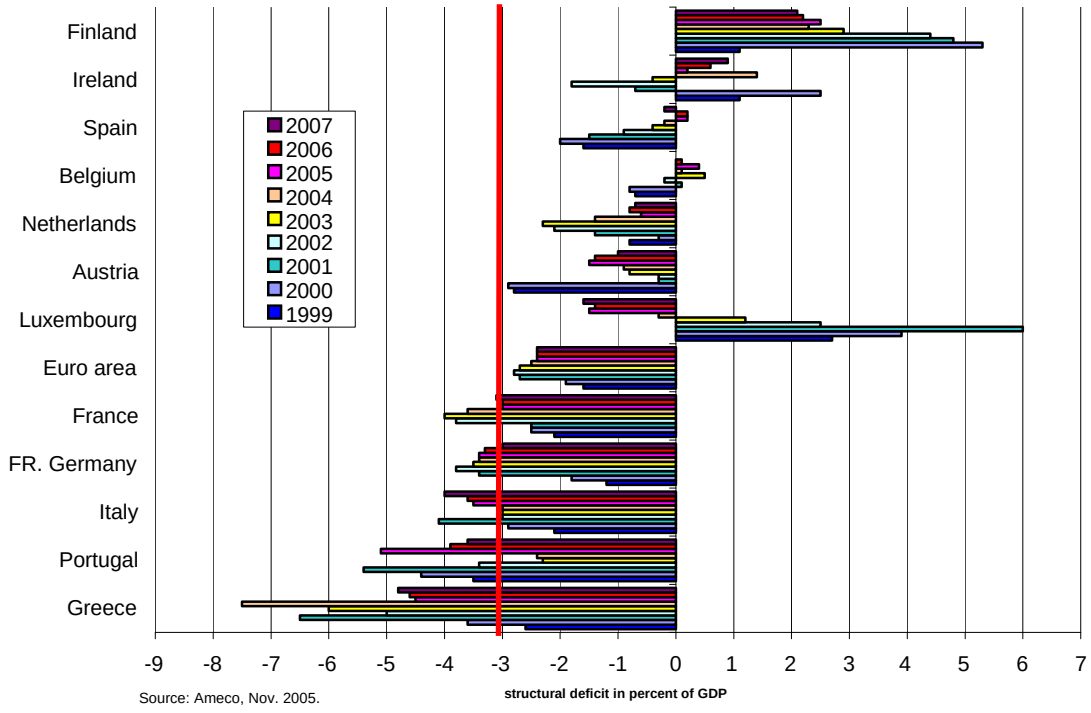
Maastricht criteria as a model, the designers of the Lisbon strategy thought that a list of structural indicators with clear goals and objectives for each member state would accelerate reforms, release synergies and ameliorate the EU's performance.
However, the logic of self-sustained policy convergence does not work for exclusive public goods, which are also called common resource goods. Here it is impossible to prevent access to the consumption of the collective goods for any member of the group and therefore it is hard, if not impossible, to make them pay for the cost of producing them. Hence, exclusive public goods create incentives for free-riding. A single member could benefit by deviating from the strategy pursued by everyone else. As a consequence, nobody will wish to conform and exclusive public goods are increasingly less likely to be produced. The resulting collective action problem has been called "the tragedy of the commons" (Hardin, 1968). It can explain many aspects of the disappointing performance of the Lisbon process, because the intergovernmental governance without EU-government, but with many national governments, has no effective mechanism for coordinating the behaviour needed to provide exclusive goods.

For example, member states are frequently criticized for not implementing EU legislation. Thus, the Commission (2005:8) writes: "In a number of Member States, key markets like telecoms, energy and transport are open only on paper – long after the expiry of the deadlines to which those Member States have signed up." The reason is a collective action problem. It is true, integrated production structures and supply chains imply that it is in the interest of each member state that all EU countries improve their competitiveness, and that this creates a common EU interest in reform (Monti, 2005). But if everyone else is liberalizing markets, it may be advantageous for individual countries to keep restrictions in place for a little longer to gain uncontested market power in the larger single market. Thus, each country has an incentive to wait with its own reforms, while pushing others to do them soon.

Fiscal policy also shows signs of coordination failure under the Stability and Growth Pact (SGP), because capital funds in EMU are a common resource good. If monetary policy aims at maintaining price stability, it will restrict the creation of liquidity, which is the

"common resource" in the financial system. But access to liquidity in the capital market is free for all. Higher structural public deficits will therefore, *ceteris paribus*, increase equilibrium interest rates and appreciate exchanges. This will lower economic growth. The SGP therefore stipulated the rule that cyclically adjusted budgets should be balanced, so that interest rates would be low. But at low rates, it is advantageous for each member state to borrow money rather than to raise taxes or cut expenditures. Hence, there exists an incentive for individual governments not to respect the Stability and Growth Pact, while publicly insisting that everyone should. Not surprisingly, structural deficits are above 2% of GDP for the whole of Euroland and not "in balance" as the Stability and Growth Pact demands (they are even above 3% for France, Germany, Italy, Portugal and Greece - see Figure 1). Long term interest rates do not come down enough to vigorously stimulate growth and employment. After major shocks like September 11 hit the economy and, contrary to the US, fiscal policy cannot compensate.

Figure 1. Structural Deficit (based on potential GDP) in Euroland 1999-2007



In monetary union, most macroeconomic policy variables, such as inflation, nominal and real interest rates, exchange rates, economic growth and employment policies have become exclusive public goods. For them, policy incentives of a governance with many governments are such, that individual member states will always be tempted to free-ride on others. It can be shown that the incentive problems caused by the exclusive nature of public goods increase with the size of the EU. The correct policy response would be either hard and constraining binding rules or policy delegation to a European institution in order to ensure a coherent and unified policy in the interest of the Union.[3] Exclusive public goods require the governance of a government. But this is what national governments keep resisting, partly because they want to keep control over their own agenda, partly because it seems difficult "to sell more Europe" to citizens, when Europe

[3] For a full elaboration of this argument and its underlying theory, see Collignon, 2003.

is already so weak: when national policy preferences are heterogeneous, centralization at the European level could undermine the EU's legitimacy even more (Alesina and Wacziarg, 1999). Thus, more delegation is not perceived as a political option.

Given these constraints, Lisbon invented the "open method of coordination" (OMC). In fact, the OMC was an accident; it came about because several governments, and in particular the German chancellor, resisted having "their hands tied", let alone delegating power to the Commission. The Portuguese presidency was also aware of the weakness of the early Prodi Commission. It therefore sought to enrol member states into an open intergovernmental process of policy coordination, where "open" meant "unconstrained". In essence, the OMC was equivalent to respecting member states' veto power. Nevertheless, governments were urged to commit to specific common policy objectives, while implementation was left to them. To safeguard against uncooperative behaviour, multilateral surveillance by the Commission and peer pressure through "naming and shaming" of non-performers was considered sufficient. The OMC was therefore a stronger form of policy coordination than simple voluntary action, but it suffered from the same dilemma as previous coordination attempts: incentives to free-ride hamper unified action to provide exclusive European collective goods (Collignon, 2003a)

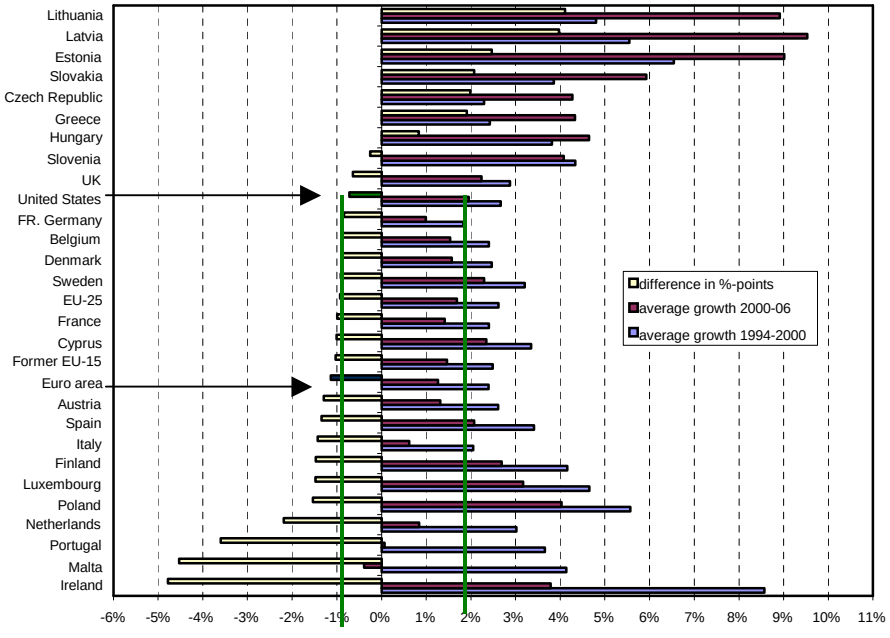
As a consequence, the economic governance of the EU has remained flawed by inefficiencies, lack of credibility and eroding legitimacy. This is now increasingly recognised, but unfortunately the logic underlying this failure is not. In its Communication to the Spring European Council, the Commission (2005) emphasised the need to create "political ownership" for the Lisbon goals. But once more, this is cheap talk. Ownership is not established by "streamlining existing guidelines" and by appointing "Mr. or Ms. Lisbon." Ownership implies property rights. Who is to be the owner for European policies? Governments or the citizens? Ownership means rights for limiting access and excluding non-performers. But this is precisely how a modern democracy works: it gives citizens the right to select and reject governments as their agents. Ownership for Lisbon implies the sovereignty of citizens and a proper European

democracy. But this is not (yet) part of Europe's agenda. Europe's economic governance needs to be re-thought in different terms.

A disappointing performance

Progress on the Lisbon strategy should be measured[4] against the headline objective of a "dynamic economy." It has been disappointing. Take per capita income growth as shown in Figure 2. Instead of increasing in the 6 years following Lisbon compared to the performance over the 6 previous years, it actually fell – except in 6 new member states and Greece, where it reflects catch-up growth. However, growth also slowed down in the United States, which is often taken as a benchmark; nevertheless, 16 countries out of 25 – including some of the biggest member states – experienced larger reductions in per capita growth than the US. Yet, despite this deceleration, average growth is still higher in Sweden, Finland, Poland, Luxemburg, Ireland and Cyprus. On average, the EU25 does not perform dramatically different from the US; however, the Euro-area seems to accumulate problems. Here, growth has been lagging behind the American economy. The US growth rate is nearly 50% higher than Euroland's.

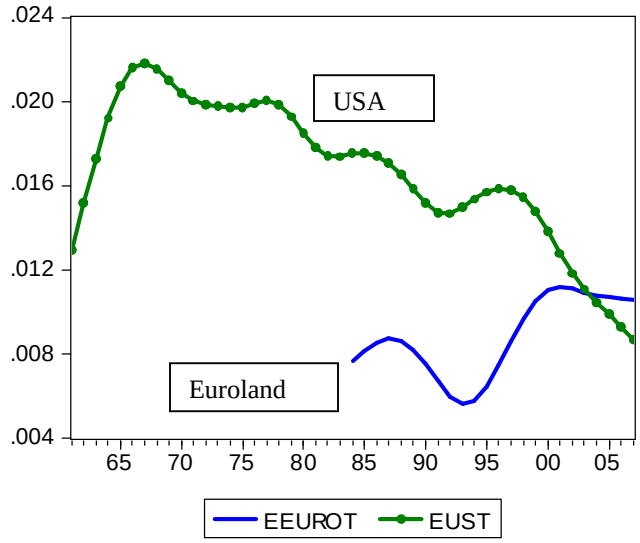
Figure 2. Average per capita Growth Rates and Differentials 2000-2006 vs. 1994-2000



[4] All figures in this paper refer to the European Commission's AMECO database, unless otherwise specified.

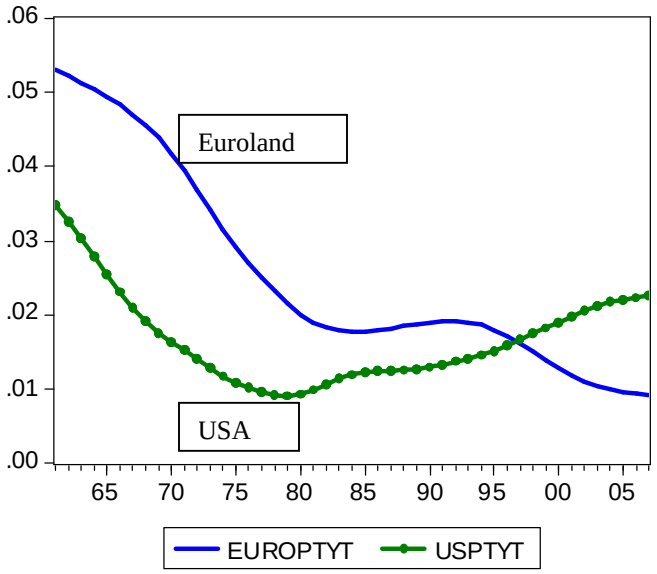
How can the slow growth in Euroland be explained? Standard growth theory tells us that economic growth can be decomposed into the growth rates for employment and labour productivity (Altomonte and Nava, 2005). Given that the Lisbon strategy was aimed at medium to long term structural improvements, we are less interested in the short term fluctuations and wish to find the longer term trends. Figure 3 shows the evolution of employment growth trends in the Euro-area and the USA after smoothing by the Hodrick-Prescott filter. Employment growth in America has had a downward trend since the 1970s, falling by more than half from over 2.1 to 0.9 percent. The Euroland time series does not go back that far, but we notice a clear increase in the second half of the 1990s and stabilisation at about 1 percent since then. Thus, in recent years the contribution from employment to growth has been higher in Europe than in the US. This is surprising, given that the labour market is often blamed for Europe's bad performance.

Figure 3. Employment Growth Trends



The main reason for the better US income performance over the last decade is exclusively due to the higher growth in labour productivity. As Figure 4 shows, labour productivity improved in the US from the 1980s on, while in Euroland it first stagnated and then deteriorated after 1990. After 1997, the growth trend for labour productivity has been higher in the United States than in Europe.

Figure 4. Labour Productivity Trends



Explaining labour productivity is not uncontroversial, but we know that it can be further decomposed into (a) human and capital investment per unit of labour, i.e. the capital intensity of production (also called capital deepening). (b) output produced per unit of human and capital investment, i.e. total factor productivity (TFP).

Total factor productivity has slowly but continuously improved in the USA since the early 1990s. In Europe it went up in the 1980s when the single market was put in place, but TFP growth has fallen again in the 1990s. See Figure 5. There are no indications that the Lisbon Council has made a difference to this development, although it may have slowed down the deceleration.

Figure 5. Total Factor Productivity Growth Trends

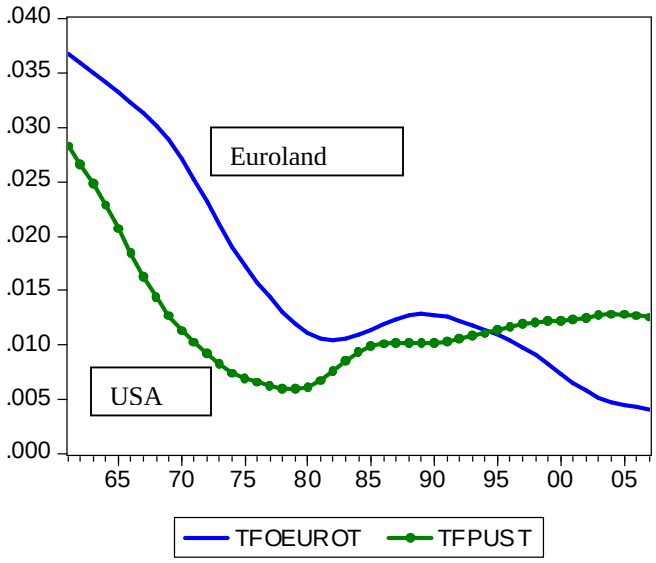
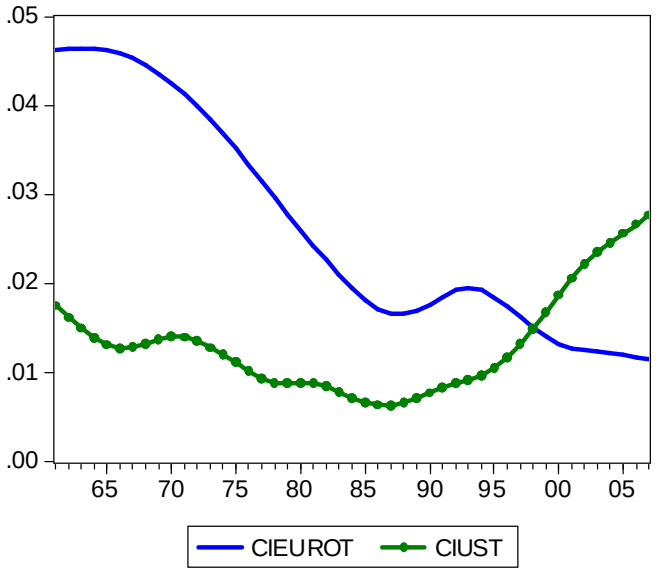


Figure 6 shows the trend performance of capital deepening. Here we find the most dramatic difference between Europe and America. The US economy has gone through a process of rapid capital deepening since the early 1990s, beating all historic records.

Figure 6. Capital Deepening Trends

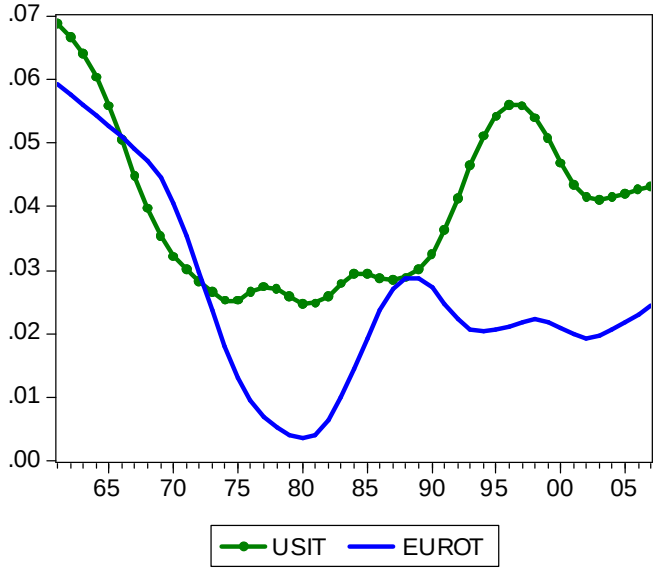


As is well known, growth in total-factor productivity represents output growth not accounted for by the growth in inputs. It is therefore dependent on a wide range of

qualitative factors, such as technological innovation, learning, social regulation etc. Europe's low performance is usually attributed to these factors. For example, Kok (2004:12) argues that the US were leaders in technical innovation, accounting for 74 % of top 300 IT companies and 46 % of top 300 firms ranked by R & D spending, while Europe was falling behind. However, while there is truth in this claim, as it would appear from Figure 5, one must not forget that innovation, knowledge, technology and skills must be incorporated into the stock of human and physical capital. Without investment, modern technology remains an abstract dream (as millions of Africans know). Figure 6 reveals that the rapid accumulation of capital per worker employed must have had a much more powerful impact on the American economy. Europe's problem, therefore, is low investment.

The differences between Europe and America with respect to investment are striking. On both continents investment growth fell dramatically in the 1970s, but in the US it stabilised in mid-decade, while it nearly collapsed in Europe amidst the monetary chaos following the breakdown of Bretton Woods (Collignon, 2002). Investment recuperated in Europe in the mid 1980, but it remained at fairly low levels. In the USA, however, investment accelerated at an unexpected rate during the Greenspan/Clinton years and seems to have settled at a permanently higher rate than in the Euro-area.

Figure 7. Gross Investment Trend Growth



The question is then: why is the rate of investment so low in Euroland? While microeconomic factors are surely important at the firm level, aggregate investment must be related to the profits entrepreneurs expect to make in their different markets. This is where aggregate demand - and therefore macroeconomics - matter, as Prime Minister Guterres had well understood when conceiving the Lisbon strategy in 1999/2000.

The "new" Lisbon Strategy

If Europe wants to become one of the most dynamic economies in the world, it will have to improve its macroeconomic management. When "relaunching the Lisbon strategy" the spring European Council in 2005 also endorsed rules for the "improved implementation of the Stability and Growth Pact" (Council, 2005). Are these measures likely to improve Europe's economic governance and performance?

The missed opportunity of the relaunch

Unfortunately, the "new" Lisbon strategy is as unlikely to succeed as the "old" one. Strategic considerations *concerning* the macroeconomic policy mix have been largely

neglected in favor of a single-minded supply-side orientation. The European Council made three points. First, the traditional theme of knowledge and innovation was re-iterated and governments and the Commission will have to produce all kinds of reports to "engage in genuine dialogue" (Council, 2005: 3). But real-life innovation only comes about when firms incorporate technology and know-how into their capital stock. Firms will only invest when they can expect to sell their output, and this is probably more important than the tax incentives for R&D envisaged by the new strategy. Secondly, member states were asked to "encourage an attractive area in which to invest and work" by "completing the internal market and make its regulatory environment more business friendly." Reducing red tape should always be welcomed, but it is hardly the stuff that will lift Europe's growth rate to 3% on its own. As Keynes and Tobin have shown, it is entrepreneurial profits that stimulate investment. Completing the common market is a necessary, not a sufficient strategy to relaunch investment. Thirdly, growth and employment is to support social cohesion. Again, there is little substance over previous Council declarations. We all know that Europe "must make work a real option for everyone." The question is: how can this be achieved?

The proper answer would have been a renewed focus on macroeconomic management as a "corollary" to supply-side reforms. Aggregate demand stimulates investment. Firms create jobs when they see opportunities for profit. Lowering labour costs by implementing structural reforms and increasing productivity may be necessary to remain competitive in the sector of international tradable goods and services, but domestic demand remains the key to economic performance. Take the UK. While supply-side reforms under Thatcher and Major have revolutionised British society, GDP in Britain increased on average 2.08 percent between 1979 and 1996, hardly more than in Mitterrand's socialist France, where it grew at 2.05 percent per annum. But with Labour's new macroeconomic framework UK GDP increased on average by 2.68 after 1997, compared to 2.08 percent in France. And the reason was hardly lack of reformism in France or supply side reforms in Britain. In Germany, unit labour costs were reduced under the Schröder government by 10 percent relative to the Euroland average, well below any other country in the monetary union. But growth has remained elusive. While

German exports exceeded those of all other countries in the world, GDP grew only by 1.1 percent p.a. from 1999 to 2006, and 1.3 percent p.a. in the 7 years before.

It is sometimes asserted that in the age of globalisation, macroeconomic management does no longer work. This is wrong. After all, the USA or the UK also live in a globalised world. If we assume that at least half of the service sector is tradable, then the share of the EU15 non-tradable value added is still above 43 % and may be even larger.[5] Hence, there is a significant part of Europe's economy where profits depend exclusively on domestic demand. Furthermore, proper macroeconomic management will also influence foreign demand through the exchange rate.

Where Europe is failing is the design of a careful stabilisation policy, where the interaction of monetary, fiscal and wage developments creates the incentive for firms to exploit profitable market opportunities. It would be wrong to focus on only one variable, such as monetary policy. In fact, the problem is not the ECB, but the impossibility to design an appropriate fiscal policy for the whole of Euroland.

Although the first few years of EMU achieved a positive policy mix with historically unprecedented job creation (2.3 million in 1999, 2.4 million in 2000, 1.9 million in 2001, but only 280 thousand in 2003), the experience was too short to make a dramatic impact on unemployment rates. This is also evident from the evolution of output gaps, which were positive in the first 4 years after monetary union started and negative ever since.[6] During the Golden Age of the 60s and 70s, the likelihood for a business to operate in an economic environment stimulated by positive demand, was 35 % higher than hitting a bad year. But in the 25 years since 1980, it has been 18 % more likely to be hit by stagnation. By contrast, the distribution of good and bad business years in the US is much more balanced (see also Collignon, 2005).

[5] I assume industry and 50% of services to be tradables, and the other 50% of services plus agriculture and construction industry to be non-tradables. Data from AMECO for 2002.
[6] The output gap data are based on potential output; see AMECO Nov. 2005, code E12.1.0.0.0.AVGDGP

The sober perspectives for the European business climate are further compounded by the high risk-adverseness of European entrepreneurs. In fact, when macroeconomic policy fails to stabilise shocks, the increased uncertainty will lead economic actors to ask for higher risk premia in the return on capital and this will lower investment. We would therefore expect a negative relation between uncertainty and the growth rate of investment (Collignon, 2002; Aghion and Howitt, 2005).

Here is some evidence. Macroeconomic uncertainty can be modelled as the volatility (i.e. the conditional variance) of the growth rate of investment. If our hypothesis is right, the expected rate of investment would be a decreasing function of the conditional variance and the coefficient would measure the risk-adverseness. We estimate the time-varying equilibrium investment rate by an ARCH-M model (Enders, 2004), where the expected growth rate depends on the volatility of investment, which is measured by the conditional variance modelled as the weighted sum of past squared surprises. In other words, firms feel uncertain about investment prospects to the degree that last year's shocks affect this years market conditions and on their experience of how much they have misinterpreted market conditions in the past. Table 1 gives the results for Euroland and the United States.[7]

[7] See also technical annex.

Table 1. ARCH-M Model for US and Euroland Investment

Estimation Equation:
==========
Investment = C(1)*GARCH + C(2)

GARCH = C(3) + C(4)*RESID(-1)^2 + C(5)*GARCH(-1)

The RESID(-1)^2 term describes news about volatility from the previous period, measured as the lag of the squared residual from the mean equation
The GARCH(-1) term is last period's forecast variance

Estimated Coefficients for Euroland:

EUROinvest = -21.976*GARCH + 0.091

GARCH = 0.00048 + 0.0049*RESID(-1)^2 + 0.833*GARCH(-1)

Estimated Coefficients for USA:

USinvest = -3.900*GARCH + 0.075

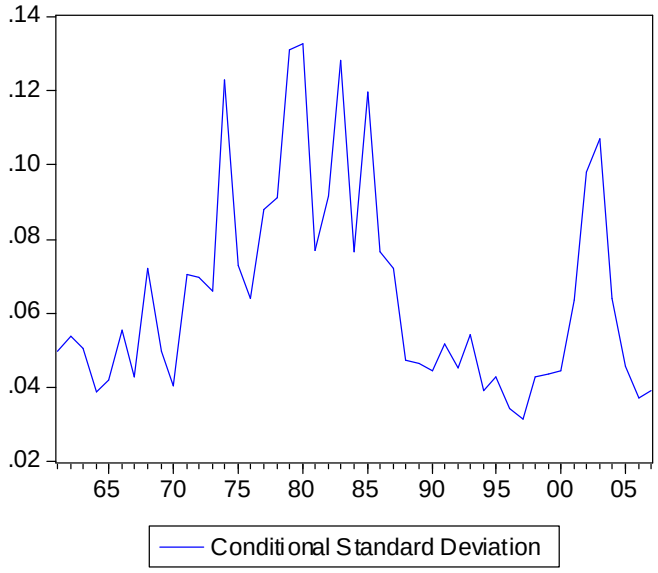
GARCH = 0.00061 + 0.659*RESID(-1)^2 + 0.302*GARCH(-1)

As expected, the rate of investment responds negatively to macroeconomic instability in both economies. However, in Europe, it is more than 5 1/2-times as high as in the US: the coefficient is –21.9 versus –3.9. Thus, maintaining a stable macroeconomic environment is significantly more important for investment and economic growth in Europe than it is in the USA. The American business community seems to be much more prepared to live with uncertainty than their European colleagues.

Maybe this is because they are more used to it. The persistence of macroeconomic shocks is much higher in the United States than in Europe: The sum of the coefficients C(4)+C(5) is 0.839 in Europe and 0.961 in the US, which implies that the half-life of a macroeconomic shock to investment is 3.6 years in Euroland, but 17.5 years in the USA. The greater uncertainty also seems to make American businessmen more alert: they make use of new information about changes in the investment rate to a much larger degree (0.659 versus 0.0049) than Europeans, who are more inclined (0.833 versus 0.302) to learn from past mistakes.

Macroeconomic stability has a major effect on the growth rate of investment in both economies. Figure 8 shows the conditional standard deviation of the US investment rate. Until the mid-1980s, instability was on the rise and aggregate investment slowed down (see Figure 7). Macroeconomic stability has returned after Alan Greenspan was appointed as Fed Chairman in 1987 and the investment rate picked up. September 11 was a major shock to the system – with the consequence of reduced investment.

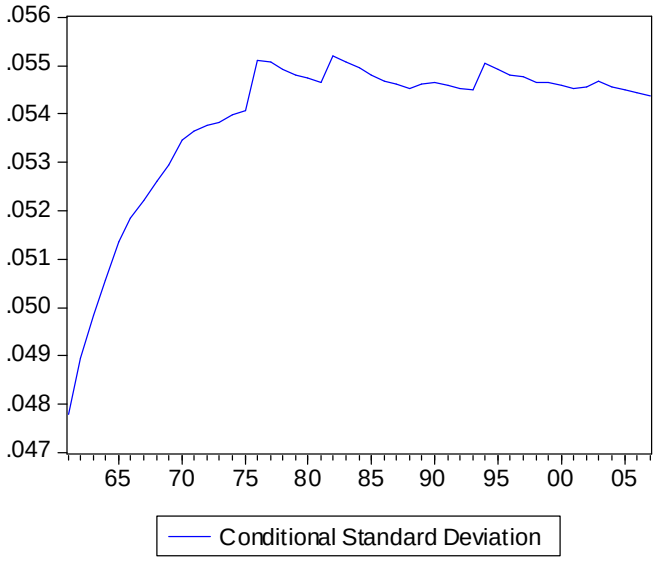
Figure 8. Macroeconomic uncertainty in the USA



In Europe, the picture is very different. Macroeconomic uncertainty dramatically increased after the breakdown of the Bretton Woods System and oil price explosion in the late 1960s and early 1970s. Since the establishment of the European Monetary System and the Bundesbank-dominated macroeconomic regime in Europe, the level of uncertainty has remained on a fairly stable plateau, with occasional ripples caused by oil prices, currency upheavals and German unification. After the start of European monetary union in 1999, shocks have been less disturbing, although macroeconomic management has not fundamentally altered the general climate of uncertainty. September 11 has only marginally affected Europeans. While the general level of macroeconomic uncertainty in the US has been twice as high as in Europe for most of the 1980s, it has fallen below European levels in the second half of the 1990s. Thus, stabilisation policies were more

successful in the United States than in the Euro area. Because Europeans are highly risk *averse*, a more active stabilisation policy would have dramatic effects on investment and economic growth in Europe. What is needed is precisely what the Spring Council 2005 has taken away from the Lisbon agenda: the optimal macroeconomic policy mix.

Figure 9.Macroeconomic uncertainty in Euroland



The Stability and Growth Pact, stupid!

What can be done to improve Europe's macroeconomic stability? In a large and fairly closed economy, the key to active demand management is the interaction between budget and monetary policy. Nominal wage developments also matter when they provoke inflationary impulses to which the central banks responds (Collignon, 1999; 2002). But wage bargaining has been a stabilising factor in the European economy for more than a decade, with unit labour cost inflation remaining well below the ECB's inflation target of 2 percent. The main difference between Europe and the United States is the pro-cyclical policy mix in Euroland and its opposite in the US.

There are two ways to represent macroeconomic policy stances (European Commission, 2005-b): one may analyse changes in fiscal or monetary policy with respect to positive or negative output gaps, or one may look directly at the interaction between fiscal and

monetary policy. The relevant variables are the change of short-term real interest rates and the change of the cyclically adjusted primary budget balance (CAPB). If the economy is characterised by a negative output gap, a positive increase in these two variables reflects a pro-cyclical move (augmenting the gap) and a negative change acts anti-cyclically. The inverse applies to a positive output gap. The classic argument for stabilisation policy consists in using fiscal and monetary policy anti-cyclically and avoiding pro-cyclicality.

From a theoretical point of view, the interaction between fiscal and monetary policy should have a negative trade-off if the economy is in equilibrium (Collignon, 2003). A loosening of fiscal policy, i.e. higher deficits, would then imply tighter monetary policy, i.e. higher interests rates, to keep inflation at bay. If both policies move in the same direction, they shift the trade-off curve. This shift may be desirable as a consequence of exogenous shocks (oil price, productivity, etc.), but it may also have de-stabilising effects, if the shocks are policy driven. I will show that this was the case in Europe, but not in the USA. The specific combination along the trade-off curve represents a specific policy mix. For example, the Reagan/Volker policy mix in the *1980s* reflected high deficits and high interest rates in the US. When Bill Clinton ran for President in 1992[8], he promised to bring the deficit down and intended to stimulate growth and employment by lower interest rates (Woodward, 2000). The high growth and macroeconomic stability in the late 1990s is characterised by the Clinton/Greenspan policy mix of budget surpluses and low interest rates. George W. Bush won the Presidency in 2000 by proposing a return to Reaganite budget policies. These longer-term equilibrium positions on the policy mix trade-off curve are implicitly determined by collective preferences over intergenerational tax burden sharing as they emerge from public debates. In particular, these debates take place during electoral campaigns when competing parties bundle policies into specific programs. Of course, citizens do not debate in abstract terms: "What is our optimal policy mix?" But when parties and candidates propose a tax cut without saying where they intend to reduce expenditure, they implicitly suggest higher deficits and therefore higher interest rates. Choosing such a candidate implies choosing a policy mix. During the 1992

[8] His motto was "It's the economy, stupid!"

elections, the budget deficit was widely discussed, due to the independent candidate Ross Perot. In 2000 Republicans promised to "return" the budget surplus to the tax payers, while Al Gore sought to use it for improving health care. The implicit choice of a policy mix is therefore at the core of any democratic society.

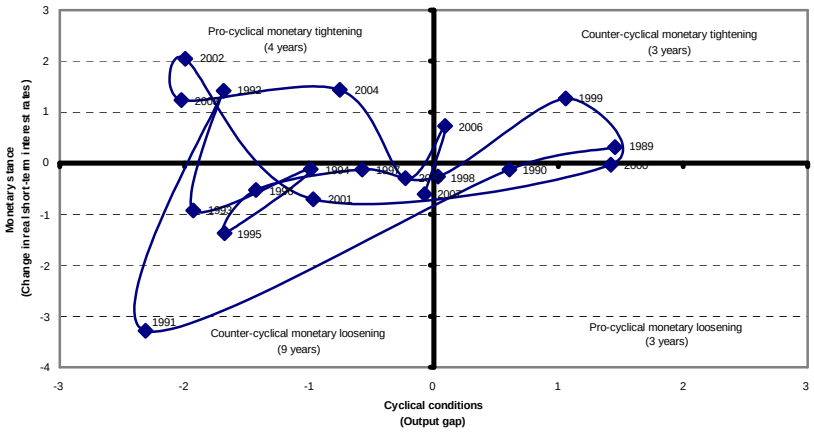
In Europe, the conduct of fiscal policy is more complicated and less democratic. From an economic point of view, what matters for the policy mix in the same currency area is the aggregate fiscal stance for the whole of Euroland that interacts with the single monetary stance of the ECB. Yet, in Europe's governance without a European government, fiscal policy is determined autonomously by 12 national governments. This creates collective action problems. The Stability and Growth Pact (SGP) imposes limits on the range of free-riding, but promises to eliminate the cyclically adjusted budget deficits have not been realised after European monetary union *started* in 1999. I have argued above that this is so because "Europe's governance with many governments" cannot deal efficiently with exclusive public goods. And fiscal policy is such a good.

The SGP has often been criticised for being insufficiently flexible. This is true, because in principle the rule of balancing structural budgets in each member state, and therefore implicitly for the whole aggregate, prevents any active macroeconomic management.[9] However, it is not sufficiently understood that the Pact imposes effectively two forms of inflexibility: it constrains effective stabilisation policy and it impedes democratic choices of the longer-term policy mix such as the implicit shift from Reagan/Volker to the Clinton/Greenspan policy mix in America. However, the lack of mechanisms for European-wide legitimisation of fiscal policy also damages the effectiveness of macroeconomic policy in reducing uncertainty.

[9] Note that the fiscal stance is defined by changes in the cyclically adjusted primary budget position. If the SGP rule demands a balanced structural budget ("Budget position in balance or surplus over the medium term"), then the cyclically adjusted primary surplus has no room for manoeuvre. Only the "automatic stabilisers" of cyclical movements will be able to give some flexibility – and this is not policy but automaticity.

Here is some evidence.[10] Figures 10 and 11 show the dimensions of fiscal and monetary policy interaction as macroeconomic stabilisation tools. We find that US monetary policy is dominated by counter-cyclical monetary policy. The Federal Reserve System counter-cyclically loosened monetary policy 9 times in 19 years, mainly in the glorious 1990s. Pro-cyclical tightening mainly occurred in recent years. The interesting mirror image is that fiscal policy was pro-cyclically tightened in the 1990s and counter-cyclically loosened in the 2000s.[11] These two opposite policies reflect movements on the policy mix trade-off curve and therefore implicitly collective preferences. Figure 10c shows interacting movements between fiscal and monetary policies mainly in the North-West/South-East direction, with some small shifts, which were presumably needed to accommodate shocks. This negative trade-off is exactly what theory would let us expect.

Figure 10a. US Monetary Stance



[10] All data used for Figures 10 and 11 come from OECD Economic Outlook, 2005

[11] It is possible that the monetary tightening absorbed some of the excessive fiscal loosening of the Bush administration. This would explain, why the macroeconomic uncertainty in 2002/3 was so strong and brought back so quickly under control, despite fiscal slack.

Figure 10b. US Fiscal Stance

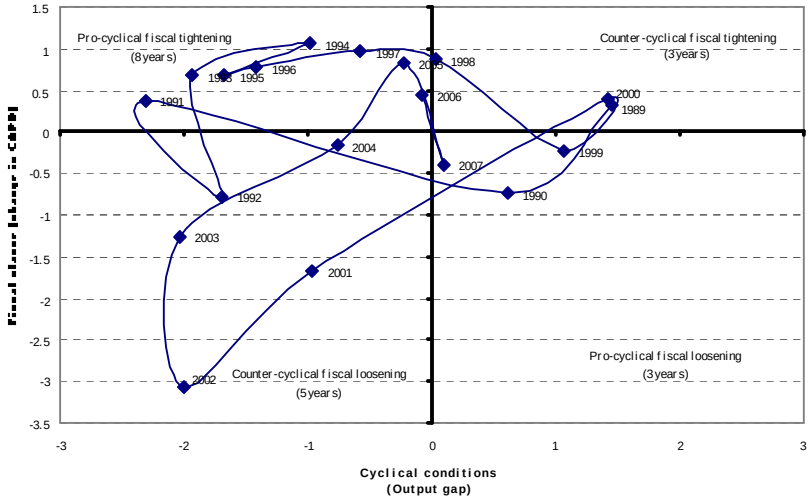
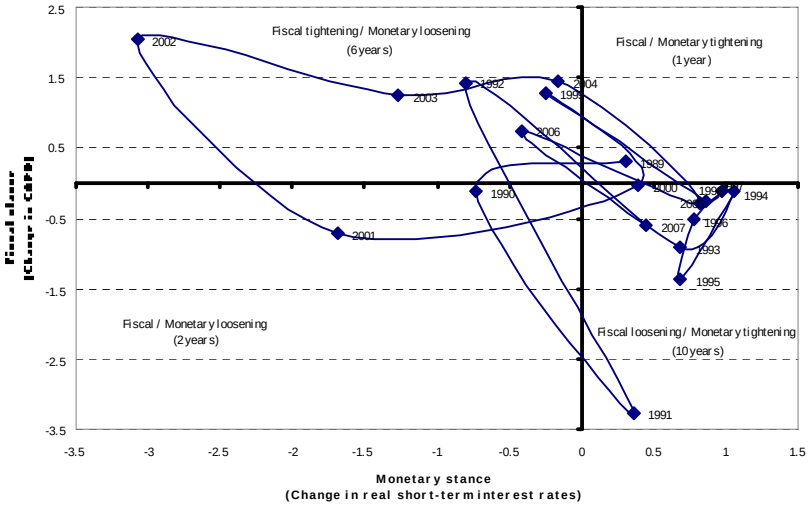


Figure 10c. US Policy Mix



Europe's picture is very different. First, note that the extreme output gap values are larger in Europe than in the USA, while policy responses are smaller. Hence, stabilisation policy is less active in Europe. Second, both monetary and fiscal policies are dominated by pro-cyclical movements. The ECB (and the Bundesbank before 1999) has a bias to pro-cyclical tightening (8 out of 19 years), and loosens pro-cyclically only occasionally in crisis years (1990 – German unification, 1992 – ERM crisis, 2001 – September 11). Counter-cyclical monetary policy in either direction has only happened in 6 years. The

same is true for fiscal policy. Counter-cyclical budget impulses are generally weak and close to neutrality, while pro-cyclical tightening in the years before EMU and pro-cyclical loosening after 1999 show the policy choices of autonomous member states. As a consequence, the European policy mix seems to oscillate between combined fiscal and monetary loosening and tightening (North-West/South-East movements). But this is odd. Theory tells us that the trade-off is negative and not positive. The explanation for this riddle is found in the collective action problem.

Assume we start in equilibrium and one government decides to borrow at the low prevailing rates. This is a demand shock that pushes the whole system into an inflationary disequilibrium and requires macroeconomic tightening. However, because fiscal policy stances are automatically determined by each member state, they cannot be used as stabilisation policy instruments. Only monetary policy has the flexibility to respond. Thus, the apparent conservatism of the ECB is the product of Europe's "governance with many governments". The monetary tightening affects economic growth in all member states negatively, so that all national budgets are now pushed into deficits. The picture of fiscal indiscipline emerges. But in reality a new equilibrium point on the trade-off curve has been reached, although the curve has shifted relative to its original position. The new equilibrium, caused by the free-riding behaviour of one actor, reflects a higher aggregate structural deficit and higher interest rates for all. Because Euroland's citizens cannot democratically determine the aggregate policy mix along a stable trade-off curve, the curve itself jumps randomly as a function of autonomous national policy choices and the central bank has a persistent bias to conservatism.

Figure 11a. Euroland Monetary Stance

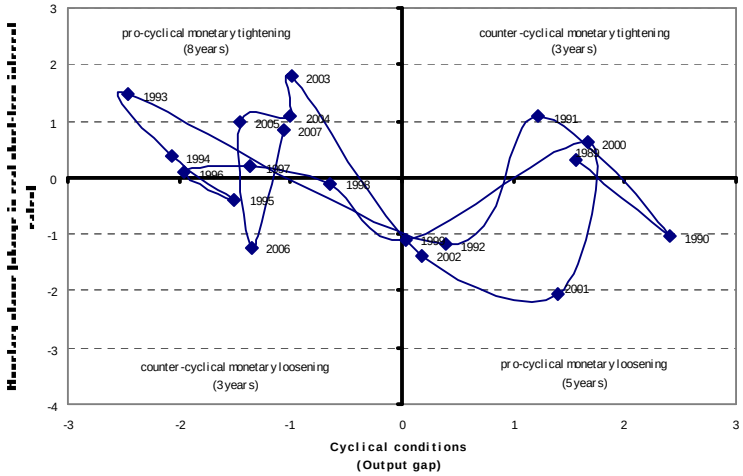


Figure 11b. Euroland Fiscal Stance

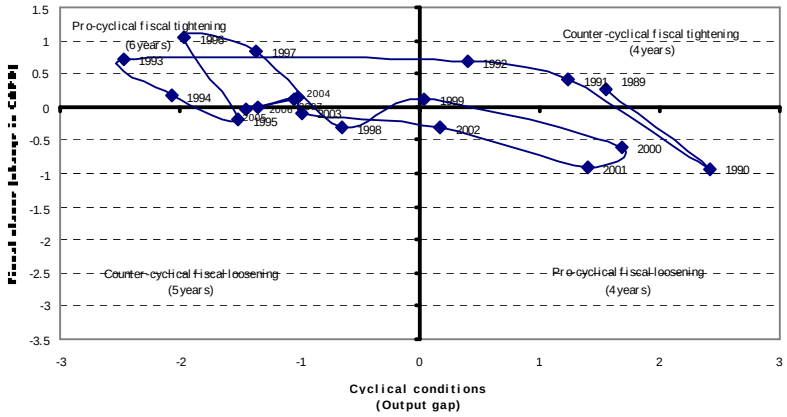
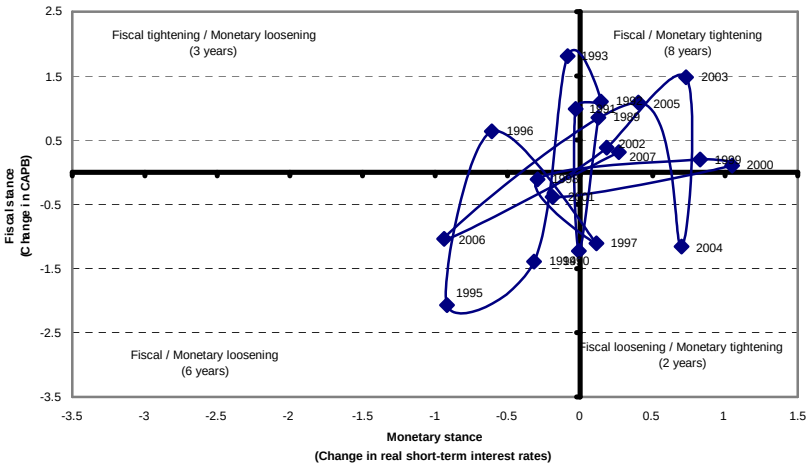


Figure 11c. Euroland Policy Mix



Increasing the efficiency of the policy mix would require turning the aggregate budget stance into a policy tool and at the same time imposing strict discipline on individual member states to stick to the defined policy. Thus, *the correct reform would be more flexibility for the aggregate fiscal policy position and less discretion for individual member states.* The "new" SGP has achieved exactly the opposite: individual countries have more leeway to justify higher deficits, while the aggregate position is a more or less random outcome of uncoordinated free-riding. The consequence are higher equilibrium interest rates, lower growth and more unemployment. Europe will remain the least dynamic region in the industrialised world economy.

One may object that after eliminating the exchange rate as an adjustment tool, national budgets must absorb asymmetric shocks in EMU. However, the likelihood and intensity of asymmetric shocks has greatly fallen in Euroland and economic growth has become more uniform. The standard deviation of the 12 euro-member states' growth rates in 2005 is only 1/3 of what it was in 1999. Euroland is converging – although to a low common growth rate. This fact highlights the increased importance of the policy mix for the whole of Euroland, while national discretion in fiscal policy would be counterproductive and damaging.

Moreover, there are some simple ideas in the public debate *about* how to design coherent yet flexible institutional arrangements for fiscal policy in Euroland (see Amato, 2002; Casella, 2001; Collignon, 2004a). For example, one may define the optimal aggregate fiscal stance at the Euro-level by transforming the Broad Economic Policy Guidelines into a "DPDF europeo".[12] This would give flexibility in reacting to macroeconomic shocks. The aggregate stance would then need to be broken down into national (and even regional) deficit quota for which each jurisdiction would obtain deficit permits. If one jurisdiction does not use its quota, it would be allowed to sell the permits to another

[12] See Amato, 2002. Documento di programmazione Economico-Finanziaria (DPEF – Document of Economic and Financial Programming) is the Italian macroeconomic framework law, which gets voted before the finance minister can put forward his annual budget. France's Vth Republic introduced a similar tool to overcome the inconsistencies of the IV Republic.

authority that wishes to borrow more. This system, inspired by tradable pollution permits, would achieve vertical flexibility reflecting fundamental preferences for borrowing and taxes, and horizontal flexibility between different jurisdictions and overall coherence in the fiscal position.

The question of democracy

However, setting up the improved institutional framework for macroeconomic policy faces the same problem as the Lisbon supply side agenda: potential benefits are huge, but national governments stand in the way of achieving them. The resistance to improved policy coordination is ultimately due to the issue of democratic legitimacy. Therefore, Europe needs to tackle the core issue of its governance: democracy.

The problem is the following. According to the classical definition, a democratic constitutional state is a political order "created by the people themselves and legitimated by their opinion and will-formation, which allows the addressees of law to regard themselves at the same time as the authors of the law" (Habermas, 2001). Thus, voting for a governmemt is the political act that allows citizens to regard themselves as the ultimate author of laws, i.e. as the sovereign. But prior to vote, political debate is a necessary condition for collective will-formation.

However, in the European Union, policy decisions are not democratic in this sense. Certainly, citizens are able to revoke national governments at national elections after a national debate has produced the collective will within this constituency. But, with respect to European collective goods, national governments act as the agent of a "principal" that is only a fraction of the European population. These national agents will then decide policies at the European level that will affect all European citizens, although they represent only the will formation of some European citizens.[13] This means that the democratic will formation in one country has externalities, which are experienced in other national constituencies. Policy compromises negotiated at the European level are

[13] In representative democracies members of parliament are elected after a national debate structured by the campaigns of political parties. These campaigns are constitutive elements of will formation. In the EU, the *Council operates more like an eternal parliament that replaces its members exclusively through by-elections,* but no campaign takes place because none is accountable to the whole European constituency.

superimposed on a majority of citizens who were not involved in the process of collective will formation and therefore do not consider themselves as "authors of law". As this process is repeated for every individual country, European policy decisions can never command the same degree of democratic legitimacy as national decisions. This creates the perception of a "democratic deficit" in Europe. Moravcsik (2002) argues that this is simply the way "advanced industrial democracies" operate, because technical functions of low electoral salience are often delegated to specialized institutions. For these matters, output legitimacy (good results) trump input legitimacy (the right to choose). This view may have been justified when European integration was relatively narrow. It may be valid for the "governance without government" that regulates inclusive public goods. But at a time when the Lisbon agenda touches every European citizens' way of life, and when fiscal coordination reaches the sacrosanct domain of "no taxation without representation", European citizens demand a right to choose. Yet, the only institutional channel through which they can express themselves is national democracy and not European democracy. As a consequence, national interests dominate the European interest and collective action problems prevent efficient policies. Europe has attained a point where the lack of input legitimacy is undermining output legitimacy.

The prospects for Europe's future are bleak, but not hopeless. If Europe continues with the undemocratic intergovernmental approach of Lisbon, it takes little imagination to see that after 50 years of European unification, the European Union will die a slow death by gridlock, economic stagnation and unkept promises. Nor can we exclude a more violent crisis with extreme right wing parties coming into power and blocking all progress. Alternatively, Europe takes a leap forward and creates a proper democracy, where European policy choices are the outcome of democratic debates, and all its citizens choose a European government. I have called this the *European Republic* (Collignon, 2003; 2004). However, the fundamental dilemma remains: which government will wish to set up a European democracy if it loses its own power? Perhaps the only way forward is that citizens mobilize themselves and work through political parties in Europe. After the collective trans-European deliberation, which follows from party competition, a new

democratic consensus might emerge and impose citizens' preferences for democracy on resistant national governments.

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Annex

Dependent Variable: EURO
Method: ML - ARCH (Marquardt) - Student's t distribution
Date: 01/23/06 Time: 01:53
Sample: 1961 2007
Included observations: 47
Convergence achieved after 49 iterations
Variance backcast: ON
GARCH = C(3) + C(4)*RESID(-1)^2 + C(5)*GARCH(-1)

	Coefficient	Std. Error	z-Statistic	Prob.
GARCH	-21.97628	40.20894	-0.546552	0.5847
C	0.091774	0.081143	1.131025	0.2580
Variance Equation				
C	0.000486	0.000680	0.715018	0.4746
RESID(-1)^2	0.004917	0.050181	0.097996	0.9219
GARCH(-1)	0.833798	0.206168	4.044261	0.0001
T-DIST. DOF	3.414917	2.075701	1.645187	0.0999

R-squared	0.050200	Mean dependent var	0.025925
Adjusted R-squared	-0.065629	S.D. dependent var	0.047951
S.E. of regression	0.049500	Akaike info criterion	-3.168441
Sum squared resid	0.100459	Schwarz criterion	-2.932252
Log likelihood	80.45837	F-statistic	0.433395
Durbin-Watson stat	1.749837	Prob(F-statistic)	0.822638

Dependent Variable: US
Method: ML - ARCH (Marquardt) - Normal distribution
Date: 01/23/06 Time: 01:33
Sample: 1961 2007
Included observations: 47
Convergence achieved after 28 iterations
Variance backcast: ON
GARCH = C(3) + C(4)*RESID(-1)^2 + C(5)*GARCH(-1)

	Coefficient	Std. Error	z-Statistic	Prob.
GARCH	-3.900078	3.489403	-1.117692	0.2637
C	0.075444	0.014965	5.041471	0.0000
Variance Equation				
C	0.000613	0.001027	0.596774	0.5507
RESID(-1)^2	0.659245	0.422289	1.561123	0.1185
GARCH(-1)	0.302244	0.323179	0.935221	0.3497

R-squared	-0.014308	Mean dependent var	0.064379
Adjusted R-squared	-0.110908	S.D. dependent var	0.066225
S.E. of regression	0.069801	Akaike info criterion	-2.562882
Sum squared resid	0.204633	Schwarz criterion	-2.366058
Log likelihood	65.22773	Durbin-Watson stat	1.488476