

Is Europe going far enough? Reflections on the Stability and Growth Pact, the Lisbon strategy and the EU's economic governance

*Stefan Collignon**

Abstract

Europe's economic governance is not only highly complex, but also increasingly inefficient and unsustainable in the long run. This conclusion is reached from the theory of collective action and the difficulties in democratic legitimacy. The solution would be the creation of a European government accountable to European citizens.

Keywords: *EMU, Stability and Growth Pact, Economic Governance, Lisbon Strategy, Open Coordination*

* Stefan Collignon is Professor of European Political Economy at the London School of Economics and Political Science.

1. Introduction

The economic governance of the European Union, and especially of the Eurozone, has seen a rapid development since the Maastricht Treaty was signed in 1992 and European Monetary Union (EMU) started in 1999. Governance means the specific ways of deciding and implementing policies through informal rules and formal institutions and a set of agreed objectives. Different institutional arrangements and policy-orientations define different regimes of governance. In this paper I will look at whether the EU's economic arrangements are consistent with its objectives.

The Treaty set the institutional framework for policy coordination through the triad of an independent European Central Bank (art. 105), the Excessive Deficit Procedure (art. 104) and multilateral surveillance through the Broad Economic Policy Guidelines (BEPG) (art. 99). Subsequently a whole range of complementing processes, methods and strategies have been introduced, starting with the Stability and Growth Pact (SGP) 1996/97, the European Employment Strategy (Luxemburg Process) 1997, the Cardiff Process 1998 for product and capital market reform, and the Macroeconomic Dialogue (Cologne Process) 1999. Some of these procedures, notably the SGP and the Macroeconomic Dialog focus more on stabilisation policies, the policy mix and demand management, others like the Luxemburg and Cardiff Process emphasise "structural reforms" and the supply side. The Lisbon Strategy in 2000 has also institutionalised the special Spring European Councils and developed the "Open Method of Coordination" (OMC), which was further fine-tuned at the European Councils in Stockholm (2001), Barcelona (2002) and Brussels (2003).

The Lisbon European Council in 2000 designed a comprehensive and integrated strategy for all these separate processes by stipulating to make Europe "the most competitive and dynamic knowledge-based economy in the world, capable of sustaining economic growth with more and better jobs and greater cohesion" (European Council, 2000) The overall strategy was based on four policy areas: (1) Transition to a knowledge-based economy and society by fostering the information society, R&D and innovation, and stepping up structural reform. (2) Completing the single market, especially for

financial services in order to facilitate higher investment. (3) Modernising the European social model by investing in people and combating social exclusion. (4) Sustaining favourable economic growth by an appropriate macroeconomic policy mix.

Progress on realizing the Lisbon agenda has been slow. Not surprisingly, the efficiency of Europe's complex governance has been questioned (Begg, Hodson, Maher, 2003; Calmfors and Corsetti, 2003; Gros and Hobza, 2001, Collignon, 2001) and concern about the democratic legitimacy of existing policy procedures ("closeness to the EU's citizens" in the language of the European Council's Laeken Declaration, 2001) has motivated setting up the European Convention now working on a European Constitution.

With the exception of the European Central Bank and possibly the Convention, all of the recent institutional innovations have strengthened intergovernmental policy coordination; no further policy conferrals to the European level have taken place, while new procedures like the Open Method of Coordination, have been extolled as "reorganising the modes of European construction" (Telò, 2002). This may reflect a general trend toward more intergovernmentalism. Yet, the optimality of this development should be questioned. While economic integration requires institutions endowed with the authority to enact Europe-wide policies, this need may be traded off against costs from imposing identical policies upon heterogeneous groups (Alesina and Wacziarg, 1999; for a critique see Collignon 2003). Therefore subsidiarity is supposed to be welfare increasing.¹

We need to understand whether the newly developed methods of intergovernmental coordination are appropriate for the tasks they are meant to accomplish. While not all European objectives need to be decided or implemented by a centralised authority, it is also clear that not all forms of intergovernmental policy coordination will

¹ However, the increasingly prominent role of the European Council and the development of the Open Method of intergovernmental policy Coordination were less a conscious decision for welfare improvement, but rather the second-best option after the failure to adopt common targets and policies. See Rodrigues, 2003.

have the same effectiveness. There is a role for both intergovernmentalism and the community method. We need to establish criteria which policy regimes are likely to produce best results.

In this paper, I will look at the different coordination regimes, which are institutionalised in the Open Method of Coordination (OMC), the Broad Economic Policy Guidelines (BEPG) and the Stability and Growth Pact (SGP) and the rules underlying their implementation. I will first discuss the need for policy coordination, and then assess their success in implementation. In conclusion I will draw some lessons for the design of a European Constitution.

2. The need for policy coordination

Externalities: the rationale for policy coordination

The institutional developments in economic policy-making reflect the recognition that “a proper functioning of EMU requires a well-developed coordination framework” (European Commission, 2002:3). This requirement is derived from the fact that although monetary policy is fully unified under the authority of the ECB, most other policy areas maintain separate national policy-making competences. Because policy preferences are defined in national constituencies, different governments have different preferences and objectives. But at the same time the growing interdependence between national economies within the same monetary framework has led to an increasing range of spillovers into other jurisdictions. Many policy variables such as common inflation, interest and exchange rates, but also the aggregate fiscal stance are now produced “jointly” (von Hagen and Mundschenk, 2002). What one member state does, increasingly affects all others and inconsistent policy objectives would lead to welfare lowering outcomes. The internalisation of these externalities creates the need for policy coordination.

Policy coordination is therefore necessary when there are autonomous and non-unified decision-makers - with possibly incompatible (disjunct) preferences and objectives - and when their actions cause spillovers into each other’s jurisdictions. Hence, policy coordination is a necessary feature of intergovernmentalism. But besides the ar-

gument of interdependence calling for cooperation, we must also consider preference change over time as a crucial element in setting up efficient governance structures. If different actors converge to pursuing the same objectives, other forms of coordination are required than if preferences are disjunct and inflexible. Furthermore, if policy objectives need to be revalued in changed circumstances, discretionary forms of policy-making are more adequate, than if one needs to stick to a given policy rule over time. These considerations determine different regimes of policy coordination, as I will explain in the next section.

Commonly, four arguments are made to explain the need for coordination and these potential benefits apply to both supply and demand side policies: (1) National actions or policies may spill over directly into neighbouring countries. For example, state aids may cause distortions in the single market and must therefore be controlled at the European level. (2) Indirect effects are particularly prevalent for European collective goods. Macroeconomic variables like inflation, interest or exchange rates concern all economic agents in Euroland and if independent national policy actions would cause the ECB to adjust monetary policy, the economic conditions in the whole area would be affected. (3) Coordination should prevent or reduce the likelihood of free-rider behaviour by member-states. (4) Some political economy theories argue that policy coordination may be useful in deflecting criticism of unpopular but necessary policy action at the national level (Drazen, 2000).

Objections to policy coordination have focused on three aspects mainly related to macroeconomic coordination and demand management: (1) The size of spillover effects and potential gains from cooperation may be small (Gros and Hobza, 2001; Curie et al. 1989). For example, the aggregate demand effect of government spending may be compensated by rising interest rates, at least if the economy is close to equilibrium. (2) Policy coordination may cause potential dangers to the independence of the European Central Bank (Alesina et al. 2001; Issing, 2002). (3) A more general objection is that the observed differences in national policy preferences require independent policies to accommodate different “tastes” (Alesina and Wacziarg, 1999). The first two objections are related to the *efficient* policy mix in Euroland, the third is about its *optimality* and is

analytically distinct from efficiency considerations. I will return to preference heterogeneity below. Here I will only insist that an efficient policy mix is a necessary condition for the sustainability of macroeconomic stability, but different policy mixes may also set different incentives for economic growth and improvements at the supply-side of the economy. Therefore there are many potential spillovers between different policy domains and coordination between independent actors is one way of achieving consistency between their actions.

However, if coordination fails to produce a coherent set of actions, delegation of decision-making to a central authority may be required. The European governance framework has tackled the issue of coordination from four different perspectives.

(1) Efficient macroeconomic policy is to ensure that the economy achieves non-inflationary, stable growth and high employment (TEU, art. 2). This implies that policy is actually capable of delivering these collective goods. Although this claim is not undisputed, it now seems to command a reasonable consensus among professional economists (Allsopp and Vines, 2000). In particular, there is agreement that inflation is ultimately always a monetary phenomenon and therefore the central bank needs to be independent to prevail against other actors when there are inflationary shocks. But this independence also requires that monetary policy-making is unambiguously centralised in the European System of Central Banks. The creation of the ECB was an indispensable condition for the consistent design of monetary policy. However, European central bank independence implies a rather unique coordination regime for monetary and fiscal policy.

(2) Even if the central bank is independent, non-cooperative games between monetary and fiscal authorities can lead to destabilising outcomes when the objectives between the two are not consistent (Sargent and Wallace, 1981). Therefore fiscal policy needs to be constrained. This was the economic rationale behind the Stability and Growth Pact. By stipulating precise rules for “avoiding excessive deficits”, the pact reduces the potentially destabilising power of fiscal authorities and frees the ECB to set interest rates compatible with macro economic equilibrium. Whether this always happens is

another matter and subject to intensive debate, but this is how the system is supposed to work. Yet, one needs to emphasise that its logic is based on the interaction between the single monetary policy and the European *aggregate* fiscal stance. Under Europe's present day economic governance, this aggregate is only indirectly defined by the SGP, which stipulates *one budget rule applying to all* - namely "close to balance or in surplus" over the medium term, so that the aggregate structural budget position is also in balance.

(3) Even if all national budgets were in perfect balance, inflationary pressures could still emerge from nominal wage settlements exceeding labour productivity increases. Sustained unit labour cost increases above the ECB inflation target would provoke monetary tightening with negative spillover effects via interest and exchange rates on economic growth in the short term, but through investment also on capacity and employment in the long run (Collignon, 1999; 2002: chapter 8). The institutional tool for internalising these externalities was the creation of the Macroeconomic Dialogue. Policy coordination under the Cologne Process has been fairly soft, i.e. non-constraining, partly because the ECB refused *ex ante* coordination as a matter of principle, partly because the nature of wage bargaining in Europe is so diversified that uniform procedures are neither applicable nor desirable. The Macroeconomic Dialogue primarily works through the improved flow of information that clarifies the macroeconomic environment for wage bargainers.

(4) An efficient policy mix will keep aggregate supply and demand in balance. But it will also have an effect on the *growth potential* of the EU economy, although the impact may be limited. The transmission mechanism from stabilisation policy to long-term economic growth works essentially through investment in the stock of physical and human capital (Collignon, 2002). Higher growth therefore requires a macroeconomic policy mix that creates an incentive for investment, but this effect would be significantly amplified if structural reform policies created positive externalities in the form of higher productivity. In the context of the European policy framework, the Broad Economic Policy Guidelines (BEPG) are supposed to internalise these reciprocal externalities between macroeconomic management and structural reforms by formulating a coherent document that gives orientation to national policy-makers. The pro-

cedures for the coordination of supply-side reforms were already set by the Luxemburg and Cardiff Processes, but only the Lisbon Strategy set out the overall design for achieving these growth and welfare improvements, with the “Open Method of Coordination” (OMC) as its instrument. The OMC is now applied in very different fields, where general guidelines or objectives at European level are being translated into national action programs (Rodrigues, 2003).

Hence, the EU has both a need for and a wide range of instruments for policy coordination. But how are they used?

Governance regimes as forms of coordination

Welfare increasing policy coordination can be modelled as a game, where the payoff to the players is highest when they coordinate their strategy. The constitutional question is which mechanisms allow independent authorities to consistently Pareto-improve welfare over time. We know from game theory that choice consistency is more easily established in sequential and repetitive games than in games with simultaneous moves,² but this advantage comes at the potential cost of dynamic inconsistency with related problems of credibility (Kydland and Prescott, 1977). As we will see, the coordination between monetary and fiscal authorities can easily be set up as a sequential game, but intergovernmental coordination, like the definition of the aggregate fiscal policy stance, can not.

Successful policy coordination has two dimensions: the consistency of objectives between autonomous partners and the dynamics in the interactions over time. If different actors make their decisions simultaneously, they may create positive or negative spillovers or externalities for others, who may anticipate them and respond by taking these decisions into account. If their strategies are mutually consistent, a Nash equilibrium exists, although the outcome is not necessarily Pareto efficient. Policy coordination is then one way of improving the outcome for both. The related compliance problems can be dealt with by setting up specific incentive structures (positive rewards, negative sanctions and institutions as commitment devices)

² For a good introductory overview, see Varian, 2003.

or by convincing others of the “rightness” of a proposed action.³ In the first case preferences remain given and fixed, and feasible outcomes are the result of strategic bargaining and side-payments. In the second case, the policy preferences actually change due to public deliberation. The relative importance given to incentives and persuasion distinguishes hard from soft coordination regimes. The flexibility by which policy objectives can be changed determines the degree of discretion versus rule-governed policy actions.

When decision-making is sequential, *ex ante* coordination is not necessary and can be replaced by *implicit* coordination. Actions are then coordinated between a leader and follower. A typical case is the interaction of fiscal and monetary policy in EMU. The ECB interprets its status of independence as incompatible with *ex ante* coordination. Indeed, if a previous commitment to coordinated policy action would constrain the ECB’s capacity to react in case of any inflationary shock, it may lose *de facto* independence and the credibility of its commitment to maintain price stability. But this does not necessarily prevent the central bank from setting interest rates at a level that is consistent with macroeconomic equilibrium. In contrast to the Sargent and Wallace (1981) framework of a ‘chicken game’, interactions between European fiscal and monetary policy should be modelled as a sequential game, where the ECB is the Stackelberg follower. The sum of national budget positions first determines the aggregate fiscal stance in Euroland, while the ECB preserves the freedom to decide which monetary policy stance is compatible with it. The potential handicaps of this institutional set-up are limited by the *ex ante* constraint of the SGP on national budget positions and by the commitment of the ECB to a conservative attitude on fiscal policy.⁴ The sequential model of fiscal and monetary policy coordination therefore reduces the inflationary dangers of “unpleasant monetary arithmetic” without jeopardizing the possibility of an efficient policy mix. Hence, monetary and fiscal policy in EMU is only indirectly and sequentially coordinated,

³ In game-theoretic terms, this means changing the payoff-matrix for specified actions.

⁴ This conservative line of insisting on the need for fiscal consolidation is frequently re-iterated in ECB publications, but also in the confidential discussions in the Eurogroup, as the author could witness in 1999.

i.e. *ex post*, and not simultaneously or *ex ante*.⁵ The ECB is apparently operating with such sequential model in mind:

“...there are no convincing arguments in favour of attempts to co-ordinate macroeconomic policies *ex ante* in order to achieve an overall policy mix favourable to growth and employment. On the contrary, attempts that extend beyond the informal exchange of views and information give rise to the risk of confusing the specific roles, mandates and responsibilities of the policies in question. They thereby reduce the transparency of the overall economic policy framework for the general public, and tend to prevent the individual policy makers from being held accountable. (...) Obviously, if national governments and social partners take the single monetary policy’s credible commitment to maintain price stability as given, when deciding on their actions, this will lead to *implicitly* coordinated policy outcomes *ex post*, while at the same time limiting policy conflicts and overall economic uncertainty.” Issing (2002)

Coordinating monetary and fiscal authorities is one thing, policy coordination *between European governments* is quite a different one. The issue is that here *sequential or implicit coordination is not possible* because the strategic interactions may resemble the prisoner’s dilemma. In this case policy coordination by contracting and punishment for defaulting would improve the policy outcome. For example, the aggregate fiscal stance is determined by all member states simultaneously. National governments retain responsibility for national budgetary and structural policies with high potential for spillovers, but they are exclusively accountable to their domestic constituencies. Hence, there is no European institution able to provide “implicit” leadership to others. But if fiscal rectitude is politically costly at home, although Pareto-optimal for the Union, a dominant strategy would be to behave with fiscal laxity. Hence the need to establish coordination rules in the form of the Stability and Growth Pact. This is probably the most prominent coordination problem in Europe today, but the argument also applies to a much wider range of policies.

Traditionally, the European Union has used four methods to deal with the externalities caused by simultaneous decision-making of autonomous governments.

⁵ The same argument can be made for the implicit “coordination” between monetary and wage policies.

(1) *Voluntary coordination* between member states. If governments can agree in advance on what they want, policies are *ex ante* coordinated through consensus. There is then no risk of default, because each individual government does exactly what they all want to be done collectively. Hence voluntary coordination requires preference convergence between different actors. Specific coordination processes serve to facilitate the emergence of a consistent policy consensus. The Macroeconomic Dialogue under the Cologne process and the Open Method of Coordination are forms of voluntary coordination where public deliberation, the exchange of information, and peer pressure through naming and shaming are to facilitate policy preference convergence. The subsequent voluntary commitment to common objectives would eliminate negative externalities and create welfare effects from policy coordination. However, this form of coordination only applies to discretionary policy making, as voluntary agreements are made case by case, issue by issue and each partner retains the full sovereignty to join or withdraw from the process. Begg, Hodson and Maher (2003) call this the “loose mode of coordination in the EU.”

(2) *Binding rules* are necessary when the short-term preferences of different actors are inconsistent with their long-term preferences. Simple voluntary adherence to coordinated policy action is not enough to ensure compliance over time, as the actors are autonomous and free to withdraw from the agreement in the future. By making a binding commitment to an agreed long-term goal, dynamic consistency between multiple policy plans can be established. However, this poses another problem: will different autonomous actors honour their commitment to the policy rule over time? If the preferences of different actors are disjunct and do not converge over time, non-compliance is highly likely and a regime of hard sanctions is required in order to deter deviating behaviour. The regime of sanctions changes the pay-off matrix and therefore the incentives for strategic behaviour. Hard policy sanctions provide perversely distorting incentives. The typical example is the Excessive Deficit Procedure, which has been further ‘hardened’ by the sanctions envisaged by the Stability and Growth Pact. Explicit Treaty provisions establish the coercive mechanisms as legally binding obligations. I will return to the question of legality below.

(3) Between hard and loose modes of coordination stands the intermediary regime of soft rules. Begg, Hodson and Maher (2003) refer to this regime as the “guided” coordination of the BEPG and the Luxemburg Process. If the policy preferences between actors converge, they are more likely to act in a similar and consistent fashion given a specific set of circumstances. A policy rule is then necessary to prevent dynamic inconsistencies, but non-compliance by individual actors is less an issue and therefore requires only a “soft” sanction regime.⁶ Soft coercive mechanisms, such as “naming and shaming”, are not legally binding, although the exchange of information, collective learning and peer pressure do contribute to the convergence of preferences. Agreed policy documents, like the BEPG or the National Action Plans for Employment, formulate rules as guidelines or focal points for medium term policies, while the implementation of policies is revalued on an annual basis, allowing a certain degree of discretion in policy making.

(4) Finally, the *community method of delegation*, now called ‘conferral’ in the new constitution draft, transfers policy-making competencies to a unified agent such as to the European Commission or the European Central Bank. In this case, policy decisions are no longer made by autonomous actors with responsibilities to different constituencies and a need for *ex ante* coordination. Instead the unified authority formulates and implements policies with respect to an enlarged constituency, internalising all externalities by *legally obliging* other actors or governments. Delegation is the appropriate policy regime when national policy preferences are disjunct and discretionary decisions need to be taken, for otherwise anarchy and conflict dominate and prevent welfare improvement.

We can summarise these different policy regimes in figure 1. The two dimensions are *preference consistency between actors* and *time consistency between actions*. Disjunct preferences require “hard” regimes of legally binding policy decisions in order to internalise the spillovers of externalities. If dynamic consistency can be achieved by formulating a general obligatory policy rule, then coordination of autonomous actors is possible, provided they stick to the

⁶ Of course, the problem of collective compliance to the rule and the temptation of dynamic inconsistencies for the coordinated policy still persist.

rules. If, however, policy decisions need to be revalued frequently and actors have disjunct preferences, they may be better off in delegating policy making to a centralised authority acting as the agent of a larger constituency. Both regimes pose questions of democratic legitimacy, discussed below. On the other hand, if heterogeneous preferences converge to a generally accepted policy consensus, due to public deliberation, mutual persuasion and learning, then the simple exchange of information and less constraining forms of policy coordination may be sufficient to improve welfare. Voluntary cooperation would be appropriate for specific discretionary issues, while a soft and flexible framework of policy rules would allow the integration of voluntary cooperation into dynamically consistent policy programs.

Figure 1: Policy Coordination Regimes

		<i>Time consistency</i>	
		Discretionary policies	Rule-based policies
<i>Preference consistency</i>	disjunct	I. <u>Delegation to unified actor</u> Commission, ECB	II. <u>Hard coordination with sanctions</u> Stability and Growth Pact, Excessive Deficit Procedure
	converging	III. <u>Voluntary coordination</u> Open Method of Coordination, Lisbon Strategy	IV. <u>Soft coordination by guiding rules</u> BEPG, Luxemburg and Cardiff Process

The evolution of these governance regimes seems to follow a trial-and-error path. When neo-functional federalists encountered resistance, they moved to softer forms of coordination which opened the way for hard coordination again. I will now ask whether we can find an underlying logic to these regime choices.

3. Collective goods: linking externalities and coordination regimes

We may interpret the outcome of policy decisions as collective goods. The classical definition of public goods is that (1) once produced they are available in the same amount to all the affected consumers (jointness of supply) and (2) that everyone must consume the same amount of the good, i.e. the supply of the good cannot be restricted to those who produced it (non-rivalness for consumption). However, as figure 2 shows, the concept of collective goods is larger. If only condition (1) holds but not (2), the collective good is called a club good; in the opposite case it is a common property resource.

Collective goods, characterised by different externalities, require different forms of governance. However, the link is not a simple transposition from figure 2 to figure 1. The crucial distinction lies in the nature of expectations formed by autonomous actors regarding their pay-offs and the implications for interactive equilibria.

Figure 2. *Typology of Collective Goods*

		<i>Consumption (Benefits)</i>	
		Excludable/rival	Non-Excludable/non-rival
<i>Supply (Cost)</i>	Non-joint/rival	I. <i>Pure private goods</i> (exclusive goods) Apples, pears.	II. <i>Common property resources</i> (exclusive collective goods) Oil wells, fisheries, Central bank liquidity.
	Joint/non-rival	III. <i>Club goods</i> (inclusive goods) Swimming pool, EMU toll highway; joint ventures	IV. <i>Pure public goods</i> (non-exclusive goods) Defence, lighthouses, streetlights.

Olson (1971) has shown that the club goods in box III of figure 2 are inclusive goods in the sense that (below a given capacity limit) an existing club may increase the total benefit from membership by admitting new members. For example, the value of my membership of a Tennis club may increase when I can draw on a larger pool of potential partners to play with. In this case the benefits of individual members are complementary to each other. The recent literature on network externalities has also observed the positive correlation between benefits and the number of group members. As Katz and Shapiro (1985) formulate it: "There are many products for which the utility that a user derives from consumption of the good increases with the number of other agents consuming the good." They defined the concept of network externality as: "[T]he utility that a given user derives from a good depends upon the number of other users who are in the same network".

The interactions between agents determine the level of payoffs and can therefore be related to collective goods. Cooper and John (1988) have provided a general framework that goes one step further to the level of actors' strategies.⁷ They show that strategic complementarities arise if an increase in one player's strategy increases the optimal strategy of the other players. This can lead to multiple symmetric Nash equilibria, where mutual gains from a possible change in strategy may not be realised, because no individual player has an incentive to deviate from the initial equilibrium. Thus, strategic complementarities would prevent an optimal allocation of inclusive collective goods, unless a mechanism is in place to ensure that coordination failure is overcome. It can be shown that inefficiencies due to strategic complementarities can be Pareto-improved by ensuring that all agents have equal access to information allowing them to deviate from an initially sub-optimal equilibrium and reap the full benefits offered by network externalities (see Benassi et al. 1994).

These models are useful for our understanding of policy coordination. In fact, the positive spillover of a given common policy on any

⁷ Technically, spillover models look at the first derivative of a collective utility function, strategic cooperation failure models focus on the second cross derivative.

individual jurisdiction would only take place, if all individual governments were convinced that their marginal contribution to the common policy has a positive effect on their own constituency,⁸ otherwise they will abstain. In this case collective preferences between autonomous actors will converge, and this is exactly what the soft policy coordination regimes in box III and IV of figure 1 are supposed to achieve: increased flow of information, exchange of best practices, peer pressure are all mechanisms to “tip” a policy network away from an initial sub-optimal equilibrium and moving it to a higher Pareto-dominated equilibrium.⁹ This logic has two implications: (1) Due to strategic complementarities, voluntary policy coordination and adherence to guiding rules will be forthcoming if, and only if, a soft institutional structure ensures the “tipping” of the preference convergence. (2) The group of decision-makers can be large, as network externalities increase strategic complementarities. Hence voluntary and soft policy coordination is the appropriate regimes for the provision of inclusive collective goods.

However, the case is different for exclusive collective goods, i.e. common resource goods (box III in figure 2). Policy coordination for exclusive collective goods is hampered by strategic substitutabilities, which can be caused by two different forms of externalities. (1) Although consumption of inclusive collective goods is the same for all group members, their access (supply) is rival, meaning that the share of benefits for each group member falls as the number of participants increases.¹⁰ As a consequence, the feedback to the expectations of existing group members is negative. This creates strategic substitutabilities i.e. the second cross derivative of the utility function is negative. The individual marginal benefit for a new or deviating member of the group is positive, but for existing or conforming members it is negative. Thus, there exists an incentive to go against the collective interest (such as the SGP) insofar as existing members’ willingness to pay for collective goods will be reduced as the number of group members increases. Large groups will therefore become “latent” in Olson’s (1971) terminology, i.e. the *likelihood of a large group providing an exclusive collective good*

⁸ For the formal deduction of this argument refer to Cooper and John, 1988.

⁹ On “tipping” see Katz and Shapiro, 1994

¹⁰ For a formal deduction of this statement see Collignon, 2003, annexe 2.

voluntarily will diminish. (2) Because benefits are the same for all group members, but access is rival, it is possible to externalise production costs to others and free-ride. For example, uncoordinated borrowing in the financial markets by any public authority could cause externalities with respect to interest and exchange rates or inflation that would affect all other authorities within the same currency area. However, the free-rider benefits from low interest rates “produced” by other member-states’ collective fiscal restraint and this creates an incentive for non-compliance with the policy rule. Therefore hard forms of policy coordination or even, as in the case of monetary policy, delegation to a European authority are required in order to provide these collective goods efficiently. The argument applies with force to the determination of aggregate fiscal policy as an instrument of stabilisation, because implicit coordination is impossible, but also to a range of other policy coordination issues, including a common foreign and security policy.

The two points can interact. The zero-sum game quality attached to common resource goods provides an incentive to keep the group of collective decision-makers small, for otherwise one risks the non-provision of the collective good.¹¹ But if the group is enlarged, the provision of collective goods will be reduced and ultimately cease. Hence, intergovernmental voluntary policy coordination will not be sufficient to provide large groups of countries with an efficient or even optimal amount of collective goods.¹² A consistent approach to policy coordination for such goods requires “hard” regimes of governance. Thus, the boxes I and II in figure 1 are governance regimes necessary for the provision of exclusive collective goods. However, it is also clear that the regime described in box II, where governments keep their autonomy, will become increasingly less effective as the European Union enlarges to new members. Strategic substitutabilities will undermine adherence to and compliance with the rules however “hard” they may be. This is the “collective action problem” of European integration. It implies that governments can-

¹¹ Olson 1971:28 argued that large groups have a tendency to provide themselves with no collective goods at all, whereas small groups tended towards a sub-optimal provision of collective goods.

¹² In Collignon 2003:113, I have discussed the welfare-enhancing role of the Franco-German axis for European integration in this context.

not be the ultimate source of European political legitimacy. Because the problem becomes more acute after enlargement, a profound re-think of Europe's economic governance in a Union of 25 or more member-states is unavoidable unless half a century of integration is to be undone.

4. Assessing Policy Coordination – The efficiency of today's regime

How efficient is the EU's economic governance? We would expect that soft coordination regimes may be sufficient to provide inclusive collective goods. But we will see now, hard coordination regimes are no guarantee for the optimal provision of exclusive goods. More integration by conferral is then the appropriate response.

In recent years, policy processes have focussed on providing *inclusive collective goods* by intergovernmental forms of coordination. This is particularly evident for objectives defined by the Lisbon Strategy that display, by definition, quasi-network externalities. Examples are policies for the Information Society, such as the deregulation of telecommunications, cyber space, digital TV, or creating a single sky. These network goods also have spillover effects on other sectors like human resources, agreeing on a Community patent or integrating a Europe-wide financial market (European Council, 2003). By following the benchmarks set out by the coordination process, member states increase their competitive advantages. Hence, there are strategic complementarities between their actions and it is not surprising that European integration has progressed in these policy areas in recent years.

However, these successes apply mainly to inclusive public goods with network externalities. For inclusive goods outside networks, progress is much slower. For example, the liberalisation of energy markets, implementing the Lamfalussy report on capital market integration, or research policies aimed at increasing R&D by the private sector have been tedious, to say the least. Little progress has been achieved on social cohesion, pension reform or a European framework for social protection that would facilitate cross border labour mobility. In most of these cases we witness little conver-

gence of national policy preferences. National governments protect particular interests relevant to their national constituencies and this prevents not only convergence, but often even the implementation of previous agreements.¹³

While soft coordination seems to work on balance for inclusive goods, the policy regime of hard coordination is facing serious difficulties, not only with efficiency, but also with legitimacy. Especially in EMU, there is now a wide range of public policies creating *exclusive collective goods*. The theory of fiscal federalism has shown (Oates, 1972) that macroeconomic stabilisation policy is an important subset of such exclusive goods. The experience with the Stability and Growth Pact has also revealed that stabilisation policies are dominated by strategic substitutabilities in the context of discretionary policies. It is less the Pact's long-term objective that poses problems, but its application in changing economic circumstances. This fact reflects well-known problems of dynamic consistency inherent in fiscal policy. But much less discussed are the issues of legitimate collective preference change. Given the autonomy of national budget policies and the preponderate role of national Parliaments, policy preferences are in fact exogenously given and disjunct. The EU has no mechanism to facilitate European-wide preference change in this domain through the deliberation of citizens and voters.

The coordination problem is reinforced by democratic preference change *within* national constituencies. A significant shift from left to right wing governments has taken place since the Lisbon European Council, reflecting the fact that policy preferences within different constituencies are not cast in stone. Some of the recently elected governments have expressed fiscal policy preferences different from what the Stability Growth Pact demands. As a consequence, they see the SGP as an obstacle and some voices have called for reform.¹⁴ Although the Pact worked quite successfully during the first two or three years of the EMU, it now seems that it only fared well during boom times and not during a recession. Yet,

¹³ The Commission has more than 1,500 legal actions pending against member states for breaches of EU legislation. (Financial Times, 23.04.03).

¹⁴ Coeure and Pisani-Ferry, 2003, discuss some proposals.

even this is doubtful. There was clearly a lack of commitment to balance structural deficits in several countries. Pro-cyclical tax cuts reinforced the subsequent difficulties in keeping to the 3 percent deficit limit. The “sinning countries”, Portugal, Germany, France and Italy are those who made the least adjustments during boom times and are now blaming the Pact for the lack of flexibility that inhibits governments from running higher deficits in adverse environments.¹⁵ These critics effectively call for more discretion in fiscal policy. However, the whole point of the Pact was to prevent this kind of ‘flexibility’. If one were to increase ‘flexibility’ in *national* budget positions (not in the aggregate stance!), the most likely outcome would be a more volatile monetary policy with less, rather than more macroeconomic stability. For more discretion in national budgets would create an uncoordinated aggregate stance. The ECB, acting as a Stackelberg-follower would have to adjust interest rates more often and this creates instability in financial markets with negative consequences for output. Hence, what is needed is flexibility in the coordinated aggregate budget position. The question arises whether the rule-based coordination between autonomous fiscal authorities can be optimal over time, if it is not delegated to the European level. This leads us to a second fault-line, which is the Pact’s lack of flexibility with respect to shifting democratic policy preferences.

The fatal flaw: Lack of democracy

National governments are accountable to their national constituencies, and ultimately democratic choice through elections will always have primacy over negotiated intergovernmental coordination. The conferral of budget policy to the EU-level is therefore problematic, for a fundamental principle of democracy is “no taxation without representation”. For this reason the Maastricht Treaty has left responsibility for fiscal policy at the national level, whilst the SGP has constrained it by the hard coordination rule: *keep structural*

¹⁵ The Commission President Romano Prodi has called the SGP ‘stupid’ because it is so ‘rigid’.

deficits in balance.¹⁶ This rule is set forever and applies to each member country. It is a technocratic rule to which democratic governments have subscribed, but there is no mechanism to deal with the problem of preference change. Inevitably this must lead to the de-legitimisation of European policies. The experience of the US can be used as a stylised reference. In the 1980's, under the Reagan/Volker policy mix, government deficits and interest rates were high, whereas under the Clinton-Greenspan policy mix in the 1990's, deficits and interest rates were low. These two different policy mixes indicate varying democratic priorities for economic policies.¹⁷ In the EU, however, the policy preference for balanced budgets in the Stability and Growth Pact is written in stone.

The choice of an efficient policy mix among an infinite variety of consistent combinations of monetary and aggregate fiscal policy must be made at the EU-level. An optimal policy mix would maximise European citizens' preferences, not those of governments. The democratic principle applied to delegation would translate into: "No European fiscal policy without representation". On other words, European collective choice requires a European constituency.

The Constitutional Challenge.

If the European Union wants to sustain and improve its legitimacy as a policy-maker, it must function as a democratic society. Hence, it will need a mechanism to formulate policy preferences by European citizens at the European level. This is less a problem for inclusive collective goods, where strategic complementarities provide the incentive for endogenous preference convergence and the Open Method of Coordination between governments will yield results. But the existence of exclusive collective goods requires not only delegation to the EU-level, but also the accountability of European policy makers to a singly European constituency. For example, as an exclusive collective good, the definition of the *aggregate* fiscal policy stance needs to be delegated to the European level, for only

¹⁶ At least that seems to be now the agreed interpretation of what it means to have "a medium-term budgetary position close to balance or in surplus".

¹⁷ See Collignon (2003): chapter 6 for a fuller discussion.

there can it be determined efficiently as a benchmark for monetary policy. However the definition of the aggregate deficit lacks legitimacy, unless it commands the consent of the majority of European citizens. The formation of collective preferences across Europe requires the democratic competition between rival elites for rival policy agendas and the involvement of ordinary citizens in European-wide policy deliberation (Hix, 2003). Clearly the control of the EU policy agenda by national governments with their bureaucratic infrastructure does not allow democratic competition.

The active involvement of citizens in EU-wide policy deliberation will happen if and only if they become voters that can censure a European government and this government will be accountable to its citizens. In the European Union this is not the case today. European policies are largely defined through deliberation in the Council, but governments' accountability is to a national and not European constituencies. Political competition takes place within member states, not within Europe. As a consequence, national interests dominate collective European interests; the universal is dominated by the particular. The 'common concern' is substituted by the concern of national governments to get re-elected and of national bureaucrats to keep their competences. Therefore what is needed is not just a *gouvernement économique*, but effectively a Government of Europe. This is not a statement of faith, but the obvious conclusion from the logic of collective action. This logic gives us compelling reasons why exclusive collective goods are unlikely to be supplied optimally by large groups of countries on a voluntary basis. Conferal of decision-making to a higher, European authority is necessary to improve welfare. A European Government, naturally evolving from the European Commission, must reflect European-wide policy preferences, but it would also contribute to their emergence by being elected by and accountable to European citizens¹⁸ or their representatives in the European Parliament. In practical terms this means that all economic policy competences for exclusive goods, such as stabilisation policy, must become a matter of co-decision with the

¹⁸ For the role of the private sector and engaged citizens in European-wide policy preference formation, see Collignon and Schwarzer, 2003.

European Parliament, rather than being monopolised by the Council.¹⁹

It is often argued that fiscal policy-making should remain at the national level because national policy preferences are heterogeneous and centralisation creates preference frustration and other inefficiencies (see for example Alesina and Wacziarg, 1999). However, this argument for subsidiarity is wrong. If a European government is liable to its citizens, the political process of electing such a government creates structures of policy competition and deliberation that will reduce preference heterogeneity and policy dissent. For the competition for individual votes by parties and candidates requires them to explain their policies and engage the electorate. Before choosing, voters seek information. New information will change old preferences. An integrated polity across Europe would emerge as a result of establishing a European government. Alternatively, if policy choices are made by national governments who are only accountable to national constituencies, policy preferences will naturally diverge and remain disjunct, given that national policy debates reflect the national constituency. Therefore the degree of dissent, preference heterogeneity and policy frustration is structurally higher if policy-making remains in the exclusive domain of national governments.²⁰

The implications for stabilisation policies in EMU are important. The weakness of the Stability and Growth Pact is not its short-term inflexibility, i.e. the degree of binding obligation, but its lack of democratic legitimacy in the long term. In fact, hard budget constraints for fiscal authorities are a necessary condition for macro-economic stability, but such institutional rules are only sustainable if they are backed by collective acceptance, expressed in the democratic choices of European citizens. The purely procedural argument that the SGP has been ratified by democratic governments is not a sufficient guarantee of its success or long-term legitimacy. What is necessary is to define the macro-economic policy stance at the European level, that coordinates implicitly the unified monetary

¹⁹ This applies in particular to the TEU articles 99, 100, 102, 103(§2), 104 (§ 6, 7, 10, 14), 107 (§6), 111.

²⁰ I have given formal models for this argument in Collignon, 2001 and 2003.

policy with the aggregate fiscal policy stance and reflects the democratic policy preferences of all citizens. (For practical implications see Amato 2002, Collignon 2003).

5. Conclusion

Europe's economic governance seems not only to be highly complex and of doubtful efficiency, but it is also unlikely to be sustainable in the long run. The Open Method of Coordination as created under the Lisbon Strategy is not the solution for the optimal provision of collective policy goods that is required to make Europe 'one of the most competitive economies' in the world. The reason is that this method is only able to achieve results in the domain of inclusive collective goods that create strategic complementarities and common synergies. But as a result of setting up EMU there is a large new class of collective goods, which cannot be efficiently provided by voluntary cooperation between national governments alone. They require not only policy coordination through hard rules to constrain deviating behaviour, but also full democratic legitimacy for their implementation. Today's policy regime, dominated by an increasing number of intergovernmental policy arrangements resembles the pre-democratic *Ancien Régime*. Unless it deals with its democratic deficit, the EU runs the risk of being thrown into the dustbin of History by a revolution, which would, unfortunately, have little to do with the noble principles that inspired European integration since Jean Monnet. The solution is endowing the European Union with a truly democratic constitution, putting European citizens at the centre rather than governmental bureaucrats. Anything else risks the disintegration of Europe, given the increasing difficulties of voluntary policy coordination in an enlarged European Union. The conflicts around the Common Foreign and Security Policy regarding the war on Iraq are early warning signs of difficult times ahead.

References

- ALESINA, Alberto, WACZIARG, Romain (1999), "Is Europe Going Too Far?" National Bureau of Economic Research. C.A. Mass. Working paper No. 6883.

- ALESINA, Alberto, GALÍ, Jordi, UHLIG, Harald, BLANCHARD, Olivier, GIAVAZZI, Francesco. (2001), "Defining a Macroeconomic Framework for the Euro Area." *Monitoring the European Central Bank*, 3, London, CEPR.
- ALLSOPP, C., VINE, D. (2000), "The Assessment: Macroeconomic Policy." *Oxford Review of Economic Policy*, 16 (4).
- AMATO, Giulio (2002), "Verso un DPEF europeo?" *Nens-nuova economia, nuova società*, anno II, luglio 2002, 4.
- BEGG, Ian, HODSON, Desmond, MAHER, Imelda (2003), "Economic Policy Coordination in the European Union." *National Institute Economic Review*, No 183, January
- BENASSI, Corrado, CHIRCO, Alessandra, COLOMBO, Caterina (1994), "The New Keynesian Economics." Oxford: Blackwell Publishers.
- BOYER, Robert (1999). "Le gouvernement économique de la zone euro. Rapport du group - Coordination des politiques macro-économiques en Europe " Commissariat Général du Plan. Paris, La Documentation française.
- CALMFORS, Lars, CORSETTI, Giancarlo (2003), "How to Reform Europe's Fiscal Policy Framework." *World Economics*, 4 (1), Jan-March 2003.
- COEURE, Benoît, PISANY-FERRY, Jean (2003), "A Sustainability Pact for the Eurozone", <http://www.pisani-ferry.net/base/re-03-keynes-sustainability.pdf>.
- COLLIGNON, Stefan (2003), "The European Republic. Reflections on the Political Economy of a Future Constitution." London: The Federal Trust/Kogan Press.
- COLLIGNON, Stefan, SCHWARZER, Daniela (2003), "Private Sector Involvement in the Euro. The Power of Ideas." London, Routledge.
- COLLIGNON, Stefan (2001), "Economic Policy Coordination in EMU: Institutional and Political Requirements." Center for European Studies (CES), Harvard University, May.
- COLLIGNON, Stefan (1999), "Unemployment, Wage Developments and the European Policy Mix in Europe." *Empirica*, 26, pp. 259-69.
- COOPER, Russell, JOHN, Andrew (1988), "Coordinating Coordination Failures in Keynesian Models." *Quarterly Journal of Economics* 103 (August): pp. 441-63.
- CURRIE, David, HOLTHAM, Gerald, HUGHES-HALLETT, Andrew (1989), "The Theory and practice of International Policy Coordination: Does Coordination Pay?" In: Bryant, R., et al. 1989: *Macroeconomic Policies in an Interdependent World*; Brookings Institution: Centre for Economic Policy: International Monetary Fund, 1989.
- DRAZEN, Alan (2000), "Political Economy in Macroeconomics." Princeton, NJ: Princeton University Press.

- EUROPEAN COUNCIL (2003), "Presidency Conclusions." Brussels European Council, 20 and 21 March 2003.
- EUROPEAN COUNCIL (2001). "Laeken Declaration."
http://europa.eu.int/futurum/documents/offtext/doc151201_en.htm.
- GROS, Daniel, HOBZA, Aleaxandr (2001), "Fiscal Policy Spillovers in the Euro Area: Where are they?" CEPS Working Document No. 176, November 2001.
- HIX, Simon (2003), "The End of Democracy in Europe?" Mimeo.
- ISSING, Ottmar (2002), "On Macroeconomic Policy Co-ordination in EMU." *Journal of Common Market Studies*, 40 (2), pp. 345-59.
- KATZ, M. and SHAPIRO, C. (1985),. "Network Externalities, competition and compatibility." *American Economic Review*, June 1985, 75 (3), pp. 424-40.
- KATZ, M. and SHAPIRO, C. (1994), "Systems Competition and Networkeffects." *The Journal of Economic Perspectives*, 8 (2), (Spring), pp. 93-115.
- KYDLAND, Finn E. and PRESCOTT, Edward C. (1977), "'Rules rather than discretion: time inconsistency of optimal plans'", *The Journal of Political Economy*, 85 (3), pp. 473-92.
- OATES, William (1972), "Fiscal Federalism." New York/Chicago: Harcourt Brace Jovanovich Inc.
- OLSON, Mancur (1971), "The Logic of Collective Action. Public Goods and the Theory of Groups." Cambridge, Mass: Harvard University Press.
- RODRIGUES, Maria J. (2003), "European Policies for a Knowledge Economy." ISCTE, University Insitute, Lisbon (Edward Elgar –forthcoming).
- SARGENT, Thomas J., and WALLACE, Neil (1981), "Some Unpleasant Monetarist Arithmetic." *Federal Reserve Bank of Minneapolis Quarterly Review*, Fall 1981, pp. 1-17.
- TELÒ, M. (2002), "Governance and Government in the European Union: the Open Method of Coordination." In Maria J. RODRIGUES, 2002. *The New Knowledge Economy in Europe*, Cheltenham (UK): Edward Elgar.
- VARIAN, Hall R. (2003), *Intermediate Microeconomics. A Modern Approach* (6th ed.), New York and London: W.W. Norton & Co.
- VON HAGEN, Jürgen, MUNDSCHEK, Susanne (2002), "Fiscal and Monetary Policy Coordination in EMU," Working Papers Central Bank of Chile 194, Central Bank of Chile.