INTERNATIONAL POLICY ANALYSIS

Democratic Requirements for a European Economic Government

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- The euro crisis has revealed the need for a fundamental reform of the Euro area's economic governance. The logic of a common currency requires that macroeconomic policymaking be centralised at the EU level; otherwise, member state governments will always undermine the common good by pursuing partial interests.

- Centralising policymaking at the European level poses the problem of legitimacy. At the core of Europe's governance is a problem of democracy. The reforms proposed by the Commission, the Van Rompuy Task Force and the Franco-German initiatives are bureaucratic and undemocratic. They will not prevent future crises.

- The alternative is to turn the European Commission into a European Economic Government, democratically controlled by the Council and the European Parliament (EP). The instrument for conducting macroeconomic policies at the European level is the newly-created »ordinary legislative process« in the Lisbon Treaty, which grounds European secondary legislation in a co-decision process between Commission, Council and European Parliament. A proposal has been made concerning how the Stability and Growth Pact could operate under such a democratic economic government.

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Introduction

In May 2010, the EU stood on the brink of collapse. Only the provision of a 750 billion euros European Financial Stabilization Facility was able to prevent a meltdown of financial markets in the Euro area that would have brought down the whole European edifice. The crisis seems to have vindicated those who have always argued that the economic governance system of the Euro area was not sufficiently strong to protect the euro against major shocks and crises. In the early years of monetary construction, French policy elites used to call for a *gouvernement économique* for the Euro area in order to strengthen the non-monetary aspects of Economic and Monetary Union. However, they never specified what that meant. In Germany, policy elites resisted the idea because they feared a French conspiracy to undermine the independence of the European Central Bank. But in the midst of the recent crisis, Chancellor Merkel rallied to President Sarkozy's renewed call for an economic government, although she specified that »the economic government is us«.[1] Responding to the Greek debt crisis, public authorities in the European Union have now set out proposals for the reform of Europe's economic governance with the aim of increasing its efficiency, but these proposals all have a serious defect: they remain focused on intergovernmental cooperation and avoid dealing with the fundamental problem of legitimising policy decisions at the European level. As a consequence, these proposals perpetuate the fallacies of the pre-crisis system and cannot prevent coordination failures between member states in the future.

But why is Europe's governance so weak that existing rules are not enforced? And what kind of incentives are needed to improve the situation? Most reformers seek to strengthen surveillance of national governments and wish to impose sanctions for non-compliance, but they fail to see that democratic governments are responsible to national constituencies, and that their responsibilities often lead them to ignore the broader collective interests of European citizens because there is no European authority that can legitimately overrule and stop their uncooperative behaviour. The core problem with Europe's economic governance is lack of democracy. This becomes clear when one asks the fundamental question, which no one is willing to address: How can member states' governments tell each other what to do, when each has been democratically elected to do something else?

1. Merkel's statement »*Die Wirtschaftsregierung sind wir*«, pronounced while standing next to the French president, sounds very much like Louis XIV's »*L'Etat, c'est moi*«.

This paper seeks to give an answer by suggesting modalities for setting up an »economic government« that has the full democratic legitimacy to act in the common interest of European citizens. Before the outlines of such a government can be traced, it is necessary briefly to analyse the shortcomings of the present system, which became evident during the recent euro-crisis, as well as the deficiencies of the policy proposals made by European authorities.

1. The Transformation of Economic Governance in the Euro Area

The philosopher Gilbert Ryle (2002) once explained that it is a category mistake to say: »The glass broke, because a stone hit it«; the correct statement is: »The glass broke because it is brittle, and a stone hit it«. In order to understand Europe's crisis and find ways out of it, we must understand how to make the system of economic governance less brittle and how to reduce the likelihood of shocks hitting the system. Solutions to both these questions require more democratic forms of governance, but the issue is complicated by the fact that the brittleness of the system invites policy shocks.

1.1 Policy Shocks and Coordination Failure in the Euro Area

The euro-crisis in 2010 was triggered by the Greek debt crisis, which was the second major shock in two years after the collapse of Lehman Brothers in 2008. The incoming new administration of Prime Minister Papandreou discovered that its predecessor had been borrowing twice as much as the officially declared six per cent of GDP, which was far in excess of the acceptable limits laid down in the EU treaties. As in other member states, these high deficits were a consequence of the revenue shortfall due to the global recession, but in Greece the situation was worsened because the Karamanlis administration had pursued irresponsible policies prior to the elections in autumn 2009. After the revelation of a 12 per cent budget deficit, the financial markets quickly developed doubts not only about the solvency of the Hellenic Republic, but also about the effectiveness of the Stability and Growth Pact with regard to avoiding defaults. When the German government, for reasons of domestic electioneering, suggested it would not bail out Greece, these worries quickly spread to other Euro area member states characterised by rising public debt and large current account deficits. Thus, an economic shock generated a political shock due to the incoherent policy structures in the EU, leading in turn to a further economic shock.

In May 2010, the danger loomed that the markets would no longer provide finance for these sovereign debtors. A sovereign default, however, would have dramatically destabilised the already fragile European banking system. This is why the European Council agreed on the European Financial Stabilisation Mechanism, by which the European Union, jointly with the IMF, set up a credit line for governments in difficulties. The ECB also agreed to buy unspecified amounts of public debt to ensure the correct functioning of markets. This rescue package was successful in restoring market confidence, although the political uncertainty with regard to how member states would deal with the crisis continues to overshadow the euro and interest rates.

The described ad hoc remedies have taken the emergency out of the crisis, but they have not made the European governance system less brittle. Policymakers have realised that they must reform Europe's governance to prevent the recurrence of similar crises in the future. However, their main focus is crisis prevention; in other words, reducing the frequency and intensity of shocks. Little has been done to make the system more robust, which would require a less diffuse and more centralised form of government in the Euro area. Policymakers seem to believe that the old brittle system of intergovernmentalism can survive, if they can prevent further shocks. For this purpose, they are seeking to establish better rules, but it is doubtful that policy rules can anticipate and prevent all exogenous shocks. This is why it is important to strengthen the system of economic policymaking from within, especially in the euro area.

With the creation of the euro in 1999, the quality of and requirements for policy coordination changed profoundly, although the methods by which Europe is governed have not. In the early stages of European integration, the development of policy cooperation among member states was driven by synergies, positive-sum games and benefits which generated incentives for nation states to voluntarily coordinate their policies. The economic literature has described these incentives under the title of club good theory, which is distinguished from the analysis of exclusive common resource goods (Cornes and Sandler 1996; Cooper and John 1988). The former are characterised by positive-sum distributional effects, meaning that due to European integration everyone was better off and no one worse off (so-called win-win situations).[2] For example, the advantages of forming a customs union, or the single market, could be calculated as the difference between trade-creating and trade-diverting effects. When the net benefits were positive, a member state had clear incentives to join the union and play by the rules. Club goods can be governed efficiently by voluntary policy coordination, although problems may arise when information asymmetries prevent governments from perceiving the potential benefits of cooperation. In this context, it was the job of the European Commission to make sure that national governments were able to see the advantages they could obtain by cooperating.

With the creation of the single market and the common currency new areas of policymaking have arisen in which such incentives can no longer be taken for granted. The logic of voluntary coordination still works well in the »old« policy areas, such as foreign trade, common agricultural policy and competition policy, but with the emergence of common resource goods, member states are easily tempted to free-ride on their colleagues.[3] Common resource goods follow the distributional logic of zero-sum effects, where actors seek to obtain benefits at the expense of their partners. Hence, common resource goods need very different kinds of governance from the earlier club goods. I will now show that this transformation of Europe's economic governance was caused by the euro, because in a currency union money is a common resource and this poses problems of collective action and coordination failure between governments, especially in the domain of macroeconomic policy.

2. See, for example, European Parliament (2010), which refers explicitly to win-win situations, without considering on zero-sum situations.

3. For a discussion of the collective action problems related to these new European public goods see Collignon (2010, 2003, 2007).

1.2 The Difference Money Makes

In any properly functioning market economy, money is a common resource that functions as the hard budget constraint. This function makes it possible for prices expressed in money terms to signal how resources can be allocated efficiently. This means that money is scarce for all economic agents who need it in advance of making purchases, regardless of whether they are private or public, firms or consumers, investors or wage earners. In the socialist economies of Eastern Europe, money was a soft budget constraint, and the transition from planned to modern social market economies consisted precisely in making money, rather than resources, the binding constraint (Kornai, Maskin and Roland 2003; Riese 1990). Modern money is created by the central bank, which has to keep it scarce in order to ensure that markets function efficiently and this is the basic principle behind central bank independence and the ECB's primary objective of maintaining price stability. If the ECB were not independent and governments could oblige it to give them money, the euro budget constraint would become soft. Price stability would be lost and resources would no longer be allocated to their most productive use by the signals of the market process.

The interest rate is the scarcity price for money, which determines the conditions under which the banking system can obtain liquidity and lend it to the »real« economy. These conditions affect all economic agents equally, even if banks and capital markets charge a premium for risk. Because the hard budget constraint binds governments and private actors alike, »sovereign« borrowers are on a par with any other debtors in the Economic and Monetary Union. Central bank independence prevents politicians from distorting financial markets and from softening the hard budget constraint. Hence, it is money that defines the Euro area as an integrated economy. From an economic point of view, a »country« is the currency area and not the jurisdiction that has more or less arbitrarily emerged from history; from a political point of view, things will, of course, appear differently and this difference in perception is the cause of many inconsistencies and conflicts.

One consequence of the hard budget constraint is that it generates policy interdependencies which have zero-sum distributional dynamics. In other words, some policies may benefit certain groups or countries, to the detriment of others. Economists typically describe this in terms of Walras' Law, which states that excess demand in one market implies over-supply in another. Although this law is traditionally formulated in static terms, it also applies to a growing economy, when money grows in proportion to the real economy. It follows that above-average growth in one sector or region implies below-average growth in others. Thus, in an integrated monetary economy, the effects and performances of one sector or region or member state are never separate from what happens in the rest of the currency area. For example, during the past decade »Southern« economies, such as Greece, Spain and, for these purposes, Ireland grew rapidly, while Germany stagnated. This has now been reversed: German growth now exceeds the rest of the Euro area, while the South is stagnating.

This economic interdependence in the Monetary Union generates political incentives for governments to free-ride on their partners. This has become very clear with the insufficient application of the Stability and Growth Pact. The logic behind this fiscal cooperation failure is as follows: because money is a scarce resource, governments that seek to borrow more money than the banking sector can supply at equilibrium must obtain the excess funds from other governments or private actors. Governments that seek to borrow less will save their own funds and therefore have excess lending capacity. Unless the lending excess is borrowed by someone else, there will be an inconsistency of monetary claims that will lead to inflation when demand exceeds the lending potential, or to unemployment when demand for money and credit lags behind. Similarly, if the policies in one member state impede or accelerate growth at home, they will also influence growth in other member states, although the interactions are ambivalent. As long as the resources in the currency area are not fully used, a boom in one country will stimulate demand and growth elsewhere; for example, the wealth effects of rising Spanish property prices stimulated consumers to buy German cars and this preserved German employment. However, these spillover effects are unequally distributed and Germany's economy has grown less than Spain's for nearly a decade. In general, and given that the ECB keeps money scarce, a local boom is possible only if local investment opportunities attract funds which are not invested elsewhere. Thus, in monetary union a local boom with above-average growth always implies slow growth elsewhere and governments have an incentive to attract funds to their own regional use at the expense of others or to borrow excessively.[4]

1.3 Policy Incentives in the Euro Area

In a monetary union, macroeconomic developments and policies are no longer simply a national concern. By sharing the same currency, and by being subject to the same budget constraints, aggregate demand and its economic consequences – such as growth and employment – have become a »common European good« that affects all citizens in Euroland jointly and this entitles them to decide collectively on how to manage them. The policies pursued by one country generate externalities for others and it is a mistake to believe that member states can conduct their affairs in isolation. This is why member states must cooperate. But when the distribution effects in an integrated economy follow the logic of zero-sum gains, voluntary policy cooperation between governments does not work, because the gains obtained by one country inevitably entail (relative) disadvantages for others and each member state will seek to reap the benefits and avoid the costs. This leads to the typical and often lamented »national egoism«. Thus, because individual governments have incentives to do the opposite of what serves the Union, common resource goods require much stronger forms of governance than have been customary in Europe. Binding rules with sanctions are then often proposed to ensure the stability and sustainability of an integrated economy and prevent damage to the common interest. However, there are policy areas in which it may be necessary to react to changes in the political and economic environment. Rules are then too restrictive and do not allow optimal policy responses and even binding rules cannot solve the problem of insufficient compliance. An independent authority *supra partes* is required to maintain the coherence of the economy. In other words, the euro area needs a proper economic government with full authority to act in the common interest of all.

4. The »Walters critique« has explained this phenomenon of »communicating vessels« in terms of differences in real interest rates in boom economies relative to the rest. However, this begs the question of why in efficient markets inflation rates can diverge between member states of a monetary union. For Eurosceptics, such as Walters (an advisor to Margaret Thatcher in the 1980s) the conclusion was to not join monetary integration. Conservative economists call for structural reforms to make markets more flexible. But if investment is driven by »animal spirits«, as Keynes observed, such rotating booms are inevitable and economic policy should aim at containing deviations from the Euro area average. To do this would be the task of an efficient economic government.

It has sometimes been argued that European integration may make it impossible for national welfare states to survive. However, this is not correct. The economic interdependence created by common resource goods does not exclude the possibility of allocating sources according to national preferences, provided this allocation does not generate externalities for everyone else. For example, spending more on public goods, such as social services and financing this by taxes on private consumption shifts the resource use from the private to the public sector without necessarily affecting the aggregate deficit in the euro area. The aggregate deficit, however, determines the total use of resources and has, therefore, external effects on interest rates, inflation, investment, growth and employment, which affect the common and shared conditions of economic development in the monetary union. It follows that in a monetary union decisions about resource allocation can remain in the national policy domain, while the Euro area's aggregate deficit (and macroeconomic policy in general) is clearly of concern to all citizens. The literature on public finance has therefore drawn the conclusion that the allocation function of government can be decentralised, while the stabilisation function of public spending must be centralised (Musgrave 1956). For Europe, the conclusion is that monetary union does not require convergence to a single social and economic model of resource use, but it does need coherence in the management of the externalities and interdependencies of public spending. The welfare state can remain national in its essential structures – for example, how it finances retirement – but it must be embedded in a larger macroeconomic framework that ensures its long-term sustainability. Unfortunately, incentives to free-ride on partners in the intergovernmental system weaken the coherence of the euro area and make it more fragile. The welfare state is not sustainable without a coherent system of governing the monetary union and this is why a European economic government is necessary to make the Euro area more robust against shocks and to preserve the European social model in all its diversity.

The problems resulting from lack of policy coherence are reinforced by policy externalities and spillover effects when nation states can act autonomously. As the European economy has become more integrated, decisions by one member state will often cause significant external effects that spill over to all other member states. As a consequence, millions of European citizens are affected by decisions of governments they were unable to elect and are incapable of influencing and these decisions constitute potential shocks to the common interest of the Union. For example, the government of Konstantin Karamanlis was elected by 1.2–1.5 million voters in 2000, 2004 and 2007, but in 2010 the consequences of his policies have hurt over 329 million citizens in the Euro area. Similarly, the German Chancellor Angela Merkel was more concerned with getting 2.6 million votes in the regional elections in North Rhine-Westphalia by catering to German chauvinism than with stabilising the euro in the midst of its deepest crisis. These examples show that what seems democratically legitimate in the context of nation states, may have devastating effects for the European Union. Thus, policies for the European Union cannot be made by member states alone.

No national government can claim that it has a legitimate right to design policies which affect all Europeans, but I will now show that the (European) Council also lacks the legitimacy to act as a European government. If the rules of economic governance permit or encourage contradictory and divergent policy behaviour, as is today the case for common resource goods, the system is not sustainable. In this case, voluntary policy cooperation between governments does not work optimally and a unified policy actor is required; member states must delegate their policymaking competences to a European institution.

2. A Democratic Framework for Reforming Europe's Economic Governance

The European Commission is the natural institution that could function as a European government. It already has the necessary administrative capacities and it is also democratically accountable to the Council and the European Parliament. The traditional role of the Commission in the Community method was to facilitate policy coordination between member states and for this purpose it had certain privileges, notably the monopoly of proposition. Member states, however, remained »sovereign« actors who would concede only case by case what competences they were willing to transfer to the Union (Bundesverfassungsgericht 2009). Thus, even if the Commission had an eminent role as coordinator, the ultimate decision-making power remained with nation states. The only genuine exception is monetary policy, where the European Central Bank was given the »independent« power of decision-making and implementing. A number of observers have recently called for an independent European Fiscal Authority to assess, design and even decide on budget policies. These ideas are clearly antidemocratic. While it is true that macroeconomic policies must be centralised at the European level, centralising more power in Brussels without strengthening democratic control by citizens is unacceptable. It is inconsistent with the most fundamental principle on which the EU is built, namely democracy. We must therefore now examine the case for more democracy in the European Union.

2.1 The Case for European Democracy

All member states in the European Union are democracies. That is a necessary condition for joining the European Union. However, national democracy has become increasingly inconsistent with the requirements for efficient policies at the European level. The so-called democratic deficit has been widely discussed and I will not rehash the arguments here. Instead, I wish to discuss the negative externalities that national policies may generate for the European public good.

National governments are elected on the basis of policy proposals that amalgamate national and European policy dimensions. Voters can choose between these packages, but they must take them as they are and cannot distinguish between their national and European interests. Because the national dimension is dominant, the decisions are also dominated by national concerns. This »bundling effect« generates the impression of »national preferences«, which governments defend when they negotiate »in Brussels«. They draw »lines in the sand«, negotiate compromises and return as heroes who have saved the »national interest« in the teeth of adversity. But given that the compromises may serve only partial interests, the general interest of all citizens is often neglected or even damaged. Note that the harmful effects of intergovernmentalism apply also to the interests of citizens who live in the member state who is declared the »winner« in the negotiations. Take Greek fiscal policies. Running large deficits may have served some social groups in Greece, but the consequences were disastrous for all Europeans, including Greeks. Germany's Chancellor, too, was seen as »winning« in the battle against financing a bailout for Greece, until the euro nearly collapsed and in the end the cost to German taxpayers was higher than if Merkel had cooperated from the outset. Thus, it is partly the bundling of national with European issues that creates negative externalities for all European citizens.

The fact that European policies are bundled in with national policies makes it impossible for citizens to choose between alternative policies at the EU level. Citizens quite understandably feel that governments do what they want and that their own preferences are continuously ignored. The lack of democracy at the EU level reduces the intergovernmental legitimacy of European policies to national constituencies and their debates, and governments negotiate under the constraint of what national debates allow them to do. As a result, intergovernmentalism generates a weak overlapping consensus between partially legitimated governments, although it rarely creates consensus between citizens. The advantage of the intergovernmental consensus is that it overcomes conflict between states, and this was the purpose of European integration after the two World Wars; but the weakness of this policy consensus is clearly a handicap when it comes to implementing policies in the collective interest of all European citizens. Therefore, in order to strengthen the effectiveness of policy coordination, the weakness of intergovernmental consensus must be compensated by democratic legitimacy emanating from citizens.

It might be objected that, in their national contexts, voters also have to accept policies that they do not like because their own preferred policies remain in a minority and they cannot design policies themselves, without political parties. But the essential difference between democracy in nation states and the lack of it in Europe is that, in national politics, political parties compete for the office of government and this makes them responsive to the debates and preferences of their potential voters; in the European Union this is impossible because there is no European government. By definition, member state governments are not accountable to a European constituency. Hence, they need to satisfy only a fraction of European citizens. By contrast, the existence of a democratically elected government at the European level would generate competition between political parties which, in order to form such a government, would need to assemble a majority and therefore offer citizens a choice between alternatives.[5] Thus, European democracy is not a matter of whether a European »people« exists, as the German Constitutional Court has argued, but whether institutions exist which allow citizens to choose and only such institutions could add legitimacy to European policymaking.

There are many theories of democratic legitimacy. In essence, they all claim that citizens must have a choice with regard to the policies that affect them. Since the French Revolution, it is generally considered that citizens, not governments, are sovereign; this means that they have the right to appoint and dismiss governments as their agents to implement the policies they choose. As Karl Popper (1996: 124) has pointed out, there are two types of government: the first type is democratic regimes, under which people can get rid of their governments through general elections; the second type – which he called »tyranny« – consists of governments which those ruled cannot get rid of. In a way, intergovernmentalism introduces a strong portion of »tyranny« into European politics because citizens cannot remove the intergovernmental consensus of the Council. Electing a government, the highest of all democratic acts, is based on general elections and universal suffrage, but the intergovernmental system deprives citizens of their democratic »nobility« because there are no general elections through which citizens could replace the Council and change its general policy orientations. They can, of course, revoke their national government – which comprises one-twenty-seventh of the ruling power – but this is hardly the same as »one man, one vote« in general elections.[6] They also can elect the European Parliament, but this parliament does not – yet – appoint a European government, indeed, not even a limited economic government, because the Council has usurped government competences. Hence, the democratic legitimacy of the European Council as a form of economic government is dubious, to say the least: it violates the democratic principle of »one man, one vote« and resembles a kind of (very) »Long Parliament«,[7] which never gets dissolved

5. Lisbon Treaties, TEU art. 10.4: »Political parties at European level contribute to forming European political awareness and to expressing the will of citizens of the Union.«

6. The impact in terms of qualified majority voting in the Council is determined by the weights in the Lisbon Treaty, Art.16 and Protocol No. 36.

7. The Long Parliament is the name given to the English Parliament convened by Charles I in 1640. It received its name from the fact that, through an Act of Parliament, it could be dissolved only with the agreement of the members, and those members did not agree to its dissolution until after the English Civil War and interregnum in 1660. The Long Parliament sat from 1640 until 1648, when it was purged, by the New Model Army, of those who were not sympathetic to the Army's concerns. Those members who remained after the Army's purge became known as the Rump Parliament.

and is never elected by general elections, but only by by-elections. Furthermore, the idea of restricting Europe's economic government to the Eurogroup is nothing more than an attempt to create a Euro »Rump Parliament«. Who would call this a democracy? If European policies are not to be seen as »tyrannical« – that is, as undemocratic – it is crucial that citizens and not governments elect an economic government.

In order to be fully accountable, a democratic government must make rules, regulations and laws for the citizens by which it is elected. No more, no less.[8] National governments cannot legitimately make laws for people that have not elected them, although it is also true that a European government must not assume the right to make policies which do not affect all European citizens collectively. The right to appoint a government makes sense only if the policymaking competences of the government coincide with the constituency that appoints it. Habermas's (2001: 65) – now classic – expression of this requirement is as follows: »The democratic constitutional state, by its own definition, 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.« The problem with European intergovernmentalism is that it violates this principle.

The solution to this problem consists of giving Europe's citizens the right to elect a European government through their representatives in the European Parliament and to limit the competences of this government to only those public goods and policies which affect all Europeans collectively. The greater part of these competences concern economic issues in the Euro area, so that, at least initially, the European government is just an economic government for the Euro area.[9] The proper democratic surveillance of such a government must be guaranteed by the fact that the European Parliament authorises the European Commission to implement specific policies of macroeconomic management and the involvement of the European Parliament in authorising the Commission would give citizens the opportunity to debate and choose the broad European policy orientations when they elect the Parliament.

The Lisbon Treaties have opened the way for new democratic practices that involve the European Parliament. The Treaties have created the »ordinary legislative process« (Art. 294) which allows the European Parliament to play its role as the representative of European citizens in economic policy as a co-decision partner with the Council. This »ordinary legislative process« lays down a procedure for the interaction of Commission, Council and European Parliament.[10] It specifies how legal acts are adopted and whom they bind (Art. 289 and 294). Because legal acts need the approval of the European Parliament, which represents European citizens as a whole, it has the potential to improve substantially the democratic legitimacy of policymaking at the European level.[11] Thus, the European Union now has an institutional framework through which European policy decisions can attain a degree of legitimacy, which was hardly accessible before. However, to realise this progress, it is necessary that the proposed reforms of multilateral surveillance of economic policies strengthen the role of European secondary legislation when regulating what is of »common concern«.

3. An Economic Government for Europe

Since May 2010, all European authorities have made reform proposals. The European Commission has formulated draft directives, which integrated the wishes of some member states for tighter surveillance and stronger implementation of the Stability and Growth Pact. The Van Rompuy Task Force (European Council 2010) also recommended exploiting to the maximum all the possibilities that EU secondary legislation can offer within the existing legal framework of the European Union. Using secondary legislation for reforms is the right approach insofar as European directives must be submitted to the »ordinary legislative process«. However, none of these authorities has made the »quantum leap« the ECB had called for.

8. The Lisbon Treaties acknowledge this under the topics of subsidiarity and proportionality. See Art. 5 TEU.

9. The high degree of macroeconomic interdependence in the Euro area (see below) justifies enhanced cooperation (Art. 20 TEU), particularly in the Euro area (Art. 136 TFEU). MEPs from member states with derogations from EMU in accordance with Art. 139 TFEU or from opt out member states (Denmark and UK) would then not vote on Euro-governance matters, but would participate in the deliberations.

10. TFEU, Art. 289: »The ordinary legislative procedure shall consist in the joint adoption by the European Parliament and the Council of a regulation, directive or decision on a proposal from the Commission. This procedure is defined in Article 294.«

11. TEU, Art. 10.2: »Citizens are directly represented at Union level in the European Parliament.«

Nor has the Task Force realised the »fundamental shift in European economic governance … commensurate to the degree of economic and financial integration already achieved through the monetary union and the internal market«, which it claims is needed. Moreover, in line with what one would expect from intergovernmentalism, the German and French governments have watered down the proposals made by the Commission, so that after decades in which the French and the Germans drove Europe forwards, Sarkozy and Merkel have effectively become a disruptive force in European integration.

Despite some divergences, the reform proposals by the Commission, the ECB and Van Rompuy all claim that they seek more effective economic policy coordination. They focus on three main areas: (i) the strengthening of the Stability and Growth Pact, (ii) a procedure for avoiding imbalances within the Euro area and (iii) an institutional mechanism for crisis management. Most proposals are compatible with the Lisbon Treaty, except the German demand to suspend the voting rights in the Council of member states which are running excessive deficits. The European Commission has produced a detailed package of secondary legislation, with four directives dealing with fiscal issues, including a wide-ranging reform of the Stability and Growth Pact (SGP), and two new regulations aimed at detecting and addressing emerging macroeconomic imbalances within the EU and the Euro area.

However, no consensus has yet been achieved concerning the nature and permanence of a crisis management mechanism. The German government wants a Treaty change in order to avoid complications with the Constitutional Court. The Task Force Report has stated: »The setting-up of a crisis resolution framework requires further work. As it may imply a need for Treaty changes, depending on its specific features, it is an issue for the European Council. The European Council may, in addition, examine other open issues, such as the suspension of voting rights.« The European Council asked President van Rompuy on 29.10.2010 to clarify whether this is feasible. However, there are few clearer violations of citizens' democratic right to representation than depriving them of their voting rights. The German position is understandable only if one considers that »citizens belong to the state«, so that one must punish the citizens if their governments do not perform. This may reflect conservative »*Obrigkeitsstaatlichkeit*« (»the authoritarian state«) à la Merkel and Sarkozy, but it is hardly compatible with a modern democracy in Europe.

We will now present a summary of these reform proposals.

3.1 Strengthening the Stability and Growth Pact

The European Commission claims that its proposals would give the Euro area the necessary capacity and strength to conduct sound economic policies, thereby contributing to more sustainable growth and jobs, in line with the Europe 2020 Strategy. It seeks to »give teeth« to an effective enforcement mechanism and to limit discretion in the application of sanctions for member states of the Euro area. In other words, the SGP would become more »rules based« and sanctions will be the normal consequence for countries in breach of their commitments. In the four draft directives the Commission proposes the following:

- The preventive part of the SGP, which is to ensure that EU member states follow prudent fiscal policies in good times and build up the necessary buffer for bad times, will be based on a new concept of prudent fiscal policymaking that allows the Commission to issue a warning in case of significant deviations from prudent fiscal policy. The corrective part of the SGP would be amended so that debt developments are followed more closely. Member states whose debt exceeds 60 per cent of GDP should take steps to reduce it by one-twentieth of the difference in relation to the 60 per cent threshold over the past three years.[12]

- A Regulation on the effective enforcement of budgetary surveillance creates a new set of gradual financial sanctions for Euro area member states. As a first preventive step, an interest-bearing deposit should be imposed when member states deviate from prudent fiscal policymaking. In the corrective part, a non-interest-bearing deposit amounting to 0.2 per cent of GDP would apply when a country is declared to have an »excessive deficit«. This would be converted into a fine in the event of non-compliance, with a recommendation to correct the excessive deficit. Interest earned on deposits and fines

12. Applying this new rule would always guarantee sustainable public debt for any member state. For a formal proof, see Collignon (2010).

would be distributed among Euro area member states that are considered »in order«.

- To ensure that these measures are not blocked by coalitions of »sinners«, a »reverse voting mechanism« is envisaged when imposing sanctions: this means that the Commission's proposal for a sanction will be considered adopted unless the Council turns it down by qualified majority. If adopted, the Commission would effectively become the European Economic Government.

- Since fiscal policymaking is decentralised, it is essential that national budgetary objectives are consistent with the unified monetary policy. The European Commission proposes that the rules of the SGP be reflected in the national budgetary frameworks. For this purpose, a directive would set out minimum requirements to be followed by member states in harmonising and coordinating their accounting systems, statistics, forecasting practices, fiscal rules, budgetary procedures and fiscal relations with other entities, such as local or regional authorities. During a »European semester«, member states would coordinate national policies with the SGP requirements.

3.2 Avoiding Macroeconomic Imbalances within the Euro Area

The crisis has revealed that member states with large public deficits often also suffer from other imbalances, notably current account imbalances. The European Commission has therefore proposed a new Excessive Imbalance Procedure (EIP). It comprises a regular assessment of the risks of imbalances based on a scoreboard composed of economic indicators. On this basis, the Commission may launch in-depth reviews of member states at risk. If it finds that these imbalances pose a risk to the functioning of EMU, the Council may adopt recommendations and launch an »excessive imbalance procedure« (EIP).

A member state under EIP would have to present a corrective action plan and the Council will set a deadline for corrective action. Repeated failure to take corrective action would be followed by sanctions, which are similar, but less severe than in the case of Excessive Deficits (a deposit of 0.1 per cent of GDP, instead of 0.2 per cent).

These ideas are at an early stage and a lot will depend on how the Commission defines the scoreboard. However, it is already foreseeable that Germany will resist correcting its surplus and there are reasonable doubts about the likelihood of sanctions being imposed on member states that run sustained imbalances.

3.3 The Missed Opportunity to Reform Europe's Economic Governance

The proposed reforms have missed the opportunity to make the European system of economic governance more robust and they will generate more political shocks. They remain entirely of an intergovernmental nature and do not extend citizens' democratic rights. This is particularly evident with regard to the reform of the Stability and Growth Pact.

The official proposals start from the assumption that rule-based policies are optimal and that problems have occurred because individual member states have not played by the rules. Hence, they propose more surveillance to detect misbehaviour earlier and suggest harsher sanctions to ensure the enforcement of rules. However, it is far from clear that this assumption is correct. While it is true that not only the Karamanlis government but most member states have frequently violated the rules of the SGP, it is also true that all member states have seen a rapid deterioration in their public finances due to the large drop in GDP during the recession. This has pushed debt levels up, often well beyond the Maastricht limits, and it is not clear at all that public debt is unsustainable in Europe. So far, no one has been able to prove that any member state, not even Greece, is effectively insolvent; in fact, I have shown evidence to the contrary (Collignon 2010). Hence, the crisis in Europe's South is a crisis of liquidity and not of unsustainable debt. Financial markets have reacted nervously because they did not see mechanisms in place that would have guaranteed the sustained re-financing of maturing debt. The European Financial Stabilization Facility, which was set up as an ad hoc crisis instrument on 9.5.2010, has calmed the markets. The lesson is that the Euro area needs to manage public debt in a more coherent fashion than under the SGP. Debt management requires not only control of deficits, but also the management of cash flows. Furthermore, a medium-term strategy to restore trust requires not only fiscal consolidation through expenditure cutting, but also raising government revenue through rapid economic growth. The SGP largely ignores the growth dimension of public deficits in a severe recession.

The failure to address the growth dimension is a consequence of the intergovernmental focus of fiscal policymaking in the Euro area. Alternative political priorities are silenced by the majority in the Council, which is able to impose its political preferences through the definition of apparently »neutral« and consensual fiscal rules. The point here is not whether the proposed policies are right or wrong, but that there is no forum in which a debate between alternative ideas and diverging policy preferences can be settled. Typically, such debates take place in parliaments, where government and opposition put forward their arguments, so that voters can approve or disapprove at general elections. Europe's intergovernmental system of policymaking prevents such Union-wide deliberation. National parliaments may have debates, but policy decisions reflect negotiated compromises between governments in the Council and no national election can ever revoke a decision made at the European level. Opposition to European economic policies can be voiced through social action (demonstrations, strikes) or by fringe parties, but there is no institutional mechanism through which the opposition could influence policy orientations. National governments sell their compromises as »There Is No Alternative« (TINA), but the consequence is a rampant erosion of the democratic legitimacy of policymaking at the European and the national level. The reform proposals for Europe's economic governance do not take this issue of political legitimacy into account.

The Global Financial Crisis has shown that a changing economic environment requires discretionary policies to deal with specific shocks. Rules are good to ensure consistency of policymaking over time when expectations are stable, but when the environment has changed or a crisis looms, a unified political authority needs to take rapid and coherent decisions. But the official reform proposals continue with business as usual. They do not ask why member states did not implement the rules they had subscribed to, nor why sanctions were never applied. They do not see that the disappointing policy outcomes of the past decade were the consequence of rational governments exploiting the opportunities for free-riding and beggar-your-neighbour. The Commission is, therefore, unable to explain why the new policy rules, with tighter surveillance or sanctions, would work better than previous arrangements.

However, economic theory teaches us that so-called collective action problems (Olson 1971) among a relatively large group of actors are always prone to produce sub-optimal results. The correct response to these problems is to delegate more decisionmaking power to a European institution in order to ensure unified policymaking with a significant degree of discretion. The European Central Bank went beyond conventional thinking when it asked for a quantum leap in Europe's economic governance and came up with the idea of the reverse voting mechanism, which would in effect assign the role of an »economic government« to the Commission. This proposal has now been accepted by the European Council for a very limited range of policy decisions regarding the imposition of penalties on member states. This gives the European Commission an eminent political role as Europe's emerging economic government, but it poses new problems of legitimacy.

3.4 The Democratic Revolution

While all reform proposals seek to improve the efficiency of the Euro area's governance, they suffer from the neglect of democratic legitimacy. Europe can no longer be governed by »enlightened despots«; citizens are now demanding that their sovereign rights be taken seriously. Europe's economic governance here reaches the core of democracy. As long as one assumes that member states are sovereign, there is no solution to the problem. If one recognises, however – and this is part of continental European political culture since the French Revolution – that citizens are the sovereign, then the solution is simple: citizens must authorise a government as their agent that conducts policies in their interests and reflects their preferences. Given that macroeconomic policy in the Euro area concerns all European citizens, they must have the right to appoint collectively a European economic government and to revoke it if they so wish. If, as the ECB suggests, the Commission is the right institution to efficiently propose policies in the common interest of Europe, the European Parliament is the only institution that can legitimise such policies in the common interest. That does not mean that national governments may not defend legitimate partial interests, but clearly the part cannot speak for the whole. The European Parliament is the representative of European citizens and it must therefore have a role in defining economic policies. The reform proposals made by institutional authorities do not recognise the Parliament as an actor and this is the biggest fallacy in their reform proposals. One must hope that the European Parliament will seize this historic opportunity to improve Europe's governance and future.

A European Economic Government may be a revolution, but it does not require changing the Lisbon Treaties. As already mentioned, a European Economic Government should logically evolve from the European Commission, which is endowed by the Treaty to serve the general interest of the Union[13] and has the necessary administrative services to do so. However, there is a danger that a Commission, which is primarily dependent on Council approval and whose president is chosen by the heads of state and government rather than elected by universal suffrage and the European Parliament, will become bureaucratic and tyrannical in the sense that it does not give citizens a choice with regard to the policies they wish to see implemented. The proper way to remedy this danger is to make use of the provisions in the Lisbon Treaties which give a right of approval to the European Parliament. This means using the »ordinary legislative procedure« for passing regulations, directives and decisions with regard to the economic policies which affect all European citizens.

The proposal to strengthen the democratic co-decision of the European Parliament in matters of economic governance implies a shift in the balance of power between European institutions, but it does not require new institutions. The Lisbon Treaties provide the necessary institutional framework. However, member states will certainly resist a democratic European government that can overrule them. Let us be clear. If Europe's economic governance is to improve, the European Parliament cannot wait to be granted the right of having a greater say by the member states: Parliament must take this right. It must risk conflicts, oppose the Council on important issues and deny the Commission approval and legitimacy, until these institutions heed the will of the European Parliament's majority.

13. Lisbon Treaty (TFEU), Art. 17: »The Commission shall promote the general interest of the Union and take appropriate initiatives to that end. It shall ensure the application of the Treaties, and of measures adopted by the institutions pursuant to them. It shall oversee the application of Union law under the control of the Court of Justice of the European Union. It shall execute the budget and manage programmes. It shall exercise coordinating, executive and management functions, as laid down in the Treaties. With the exception of the common foreign and security policy, and other cases provided for in the Treaties, it shall ensure the Union's external representation. It shall initiate the Union's annual and multiannual programming with a view to achieving interinstitutional agreements.«

4. Democratic Reform of Europe's Economic Governance

This paper is about making Europe's economic governance more democratic. Because fiscal policy is so crucial to the implementation of coherent macroeconomic policies, I will now sketch out some ideas on how to strengthen the role of the European Parliament in a reformed Stability and Growth Pact. These ideas will, of course, require more detailed technical and political discussion. However, the principles used for this purpose can be extended to other policy areas.

4.1 Democratic Reform of the Stability and Growth Pact

We have seen how important it is for economic growth and employment to define the aggregate budget deficit at the Euro area level. However, there can be no question of a large centralised federal budget. Budgetary policy remains a prominent area of national responsibility with regard to the allocation of resources. The European budget represents less than one per cent, while in the European Union aggregate public spending of member states represents roughly 50 per cent of the Union's GDP (European Commission 2010a). However, what matters for macroeconomic stability is the aggregate budget position of all member states and therefore it is necessary to define and implement an aggregate budget stance that responds to the changing requirements of the business cycle. Because the aggregate fiscal position is dependent on each member state's contribution, the surveillance of national budget policies is important. It is, therefore, reasonable that reforms of Europe's economic governance focus on how to »reinforce compliance with the Stability and Growth Pact and deeper fiscal policy coordination« (European Commission 2010).

However, there are significant problems with the reform proposals made by the Commission and the Council. First, the Council suggests purely intergovernmental policy coordination (with the Commission as handmaiden). We have seen that voluntary policy coordination works only for European club goods, but not for the common resource goods created by monetary union. Second, the proposals seek bureaucratic instead of democratic procedures for surveillance and penalties. With these reforms, we are heading for a pre-democratic *ancien* *régime*. Third, there is no intrinsic mechanism that can ensure the implementation of bureaucratic policy surveillance because national parliaments alone have the legitimacy to decide on taxes, spending and debt. There is no guarantee that they will do what would be optimal at the European level because governments respond to the partial interests of their constituencies. It is therefore highly doubtful that the proposed reforms of Europe's economic governance will avoid future crises. A different approach is needed.

In an earlier paper (Collignon 2010a), I referred to the idea of tradable deficit permits (Casella 2001) and linked it to the formulation of the Broad Economic Policy Guidelines (see also Amato 2002). This proposal could open a significant democratic dimension to Europe's fiscal policy by taking the following measures:

- The Economic Guidelines would become a Union legal act that defines the general policy orientations and decides on the optimal borrowing requirement for the Euro area, that is, the aggregate budget deficit which is considered consistent with the economic environment (business cycle) and the structural requirements of the European economy (public investment, aging and so on). On the basis of the assessment made by the Commission, the Council together with the European Parliament would pass a directive that would define the aggregate amount of borrowing permits for the Euro area that will give public authorities the right to issue new debt. The directive will also allocate these permits to member states in accordance with procedures described below.

- The European Parliament will have an active role in the formulation of the desirable aggregate policy stance. Art. 136(b) of the TFEU requests that the Council »set out economic policy guidelines for [member states in the euro area], while ensuring that they are compatible with those adopted for the whole of the Union and are kept under surveillance«. *A priori*, this excludes the Parliament. However, who would object to the Council's stipulating, with reference to Art. 289 and 290, that through an ordinary legislative procedure the Economic Guidelines will define the desirable aggregate deficit of the Euro area? Political will is the key to such reform.

- If the aggregate budget position regulates the external effects of public spending arising from national budget policies, member states must implement the allocation of public resources in a way that is consistent with the common policy stance. For this purpose, each member state must be allocated a share of the total borrowing authorisation. The obvious criterion for this allocation is the relative share of GDP, but one could imagine modifications to this distribution that reflect other criteria, such as excess over the 60 per cent debt ratio.

- Some member states may wish to borrow more than they have been authorised. The coherence of fiscal policy can be maintained only if excess borrowing by some countries is compensated by less borrowing in other countries. Hence, there must be the possibility of horizontal transfers of borrowing permits. Inspired by tradable pollution permits, such transfers could be traded in a special market. Table 1 provides an indication of the size of such transfers based on the actual borrowing of the Euro area in 2009.[14] Total borrowing was 574.7 billion euros, 6.5 per cent of GDP. Assuming that this was the desirable amount of aggregate borrowing in the crisis situation, Germany's borrowing share was only half of its GDP weight and Spain's nearly double. With the tradable permit system, the request of excess borrowing by Ireland, Greece, France and Spain could have been authorised by unused permits from Germany, Italy, the Netherlands, Finland and Austria.

- The idea of creating borrowing permits through the ordinary legislative procedure will also facilitate the surveillance and implementation of the agreed common fiscal policy. A European law in the form of a directive could oblige financial institutions to lend to public entities only if they can present borrowing permits for the required amount. This ensures that no government can violate the budget position considered optimal by the democratic institutions of the European Union. Thus, contrary to the bureaucratic surveillance proposed by European authorities, the system of borrowing permits would confer democratic legitimacy on defining the desirable aggregate budget position for the Euro area and decentralise policy implementation, which would be policed by markets that simply apply the law.

14. Luxemburg and Malta were insignificant borrowers in this context and are left out of the table.

Conclusion

This paper has argued that Europe's economic governance cannot be improved by tightening policy rules for intergovernmental policy cooperation. This system remains fragile because well-known collective action problems prevent coherent policy action when exogenous shocks hit the economy. Especially since the creation of the euro, there are strong incentives for national governments to seek benefits at the expense of their neighbours. To remedy this potentially disruptive and destructive tendency, macroeconomic policymaking in the euro area must be centralised in a European economic government, which would naturally emerge from the European Commission and use secondary legislation to govern the economy. However, this centralisation of power can be justified only if such a government can be democratically controlled and therefore the European Parliament, as the representative of citizens, must be fully involved in passing such secondary legislation by making use of the »ordinary legislative process« set up in the Lisbon Treaty.

Such democratic control of the Commission requires, therefore, the politicisation of Europe's economic government. Political parties must offer competing policy programmes so that voters can have a choice. Presenting party candidates for President of the Commission prior to the election of the European Parliament would mobilise voters. As a first step to a truly democratic Europe, it is now time that Europe's progressive forces push for a democratic economic government in the Euro area.

Table 1. Deviations from aggregate borrowing requirements

	%-Shares in:		Difference	
	Borrowing	GDP	% of GDP	€ bn
Germany	14.0	27.3	-13.3	-76.6
Italy	13.9	17.0	-3.1	-17.6
Netherlands	4.7	6.3	-1.6	-9.1
Finland	0.9	2.0	-1.1	-6.4
Austria	2.1	3.0	-0.9	-5.3
Belgium	3.5	3.8	-0.3	-1.9
Cyprus	0.2	0.2	0.0	-0.2
Slovakia	0.7	0.7	0.0	0.0
Slovenia	0.4	0.4	0.0	0.1
Portugal	2.2	1.8	0.5	2.8
Ireland	3.6	1.5	2.0	11.8
Greece	5.3	2.6	2.7	15.8
France	28.0	22.0	6.0	34.6
Spain	20.5	11.5	9.0	52.0
Euro Area	100.0	100.0	100.0	100.0
Total EA € bn	**574.7**	**8908.5**	**6.5%**	

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