

Whither Europe?¹

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1. Introduction

Where I live, on the West Coast of the United States, and teach, at the University of California, Europe seems far away. Geographically we are closer to Latin America and Asia. Ethnically, Californians of Hispanic and Asian-American descent are increasingly numerous. Within 20 years, residents of European origin will be a minority; already they are a minority of the undergraduates enrolling at Berkeley. Economically as well, we look to Asia. It is in California where the largest number of container ships arriving from Asia are unloaded, and it is across the Pacific, and in China in particular, that most of those containers originate. Increasingly intimate corporate and personal ties are being forged between chip designers and software engineers in Silicon Valley on the one hand and Bangalore and Taipei on the other. And, to come to the less happy aspect, we worry less, compared to residents of, say, the Upper Midwest, about anthrax and dirty bombs than about the ability of North Korea to target the United States with ballistic missiles.

¹George C. Pardee and Helen N. Pardee Professor of Economics and Political Science at the University of California, Berkeley. This is the text of the Monroe Lecture delivered at Kalamazoo College, May 2003. These remarks owe much to ongoing discussions with my colleagues in the Institute of European Studies at the University of California, Berkeley. I draw liberally on ideas from three reports on which I collaborated with colleagues: the report of the international commission of experts convened by Britain in Europe to investigate the implications for the UK of staying out of the euro (Begg et al. 2003a); the 12th report on Monitoring European Integration on the political architecture of Europe, commissioned by the Centre for Economic Policy Research (Berglof et al. 2003); and CEPR Policy Paper no. 10 on sustainable regimes of capital movements in accession economies (Begg et al. 2003b).

Where I live, it is also hard to invoke current events to stimulate audience interest in Europe. Europe seems like an economic backwater. Growth is slow; unemployment is high; there are relatively few signs of the New Economy. Germany, which accounts for a third of Europe's gross domestic product, is suffering particularly dramatic economic difficulties. By American standards, there is a noticeable lack of tolerance for migration and ethno-cultural diversity, and extremist parties have made headway from Austria to the Netherlands. The European Union is currently engaged in a contentious effort to remake itself politically. And while Europeans seem temperamentally unable to speak with one voice on matters of foreign and security policy, when they do speak they instinctually articulate a position contrary to that of the United States.²

But to neglect developments in Europe is to neglect a singularly important body of evidence on the forces and processes shaping the world in the 21st century. Europe has agreed to undertake an unprecedented economic experiment by enlarging its union to include an additional 10 countries and 80 million Central and Eastern Europeans. The impact will be not unlike that on the United States of negotiating the NAFTA agreement with Mexico, except that effects will not be limited to trade; they will include also labor mobility after a short transitional period, as

²International relations theorists refer to this tendency as "balancing." Readers may perhaps recall the episode in February 2003 when French President Jacques Chirac berated the accession economies (EA's) of Eastern Europe, soon to be new members of the EU, for supporting the United States in the debate over what policy to adopt toward Iraq. Chirac's complaint, according to a 20 February 2003 article in the *New York Times* (Smith 2003), was that the AE's wished to join the EU merely for its economic benefits and not in order to form a political block that might form an effective counterweight against the United States. Dominique de Villepin, the French foreign minister, put this pithily when he warned that "Europe is not a cash register" (Smith 2003, p.14). The episode is revealing both of French perceptions of the essential nature of Europe and the importance attached by its governments to balancing.

well as other forms of economic integration. This integration is deeper and more extensive than in other parts of the world. Consequently, we should be able to learn important lessons from Europe about the effects and management of globalization.

In addition, Europe has created a monetary union initially of 11, now 12, and soon an even larger number of member states, complete with a single currency and a European Central Bank. A monetary union on this scale is a singular achievement, something to which Asian and Latin American countries aspire but are unlikely to achieve anytime soon. It has allowed Europe to banish the problem of exchange rate instability and crises by eliminating intra-European exchange rates. Thus, its experience should allow us to identify the preconditions for attaining comparable levels of monetary and financial stability in other parts of the world. Finally, Europe is engaged in an unprecedented political experiment whose most visible manifestation is its constitutional convention. To be sure, Europeans have mixed feelings about political integration. They treasure their national identities. Sovereignty is jealously guarded, especially in the UK and the continent's smaller countries, where federalism is an f-word. At the same time, there are compelling reasons to contemplate the creation of stronger central institutions. A functioning single market requires EU-level regulation, in some domains at least, which in turn requires an EU political body with the power to hold economic policy makers accountable for their actions. This need is already evident in the case of the ECB, which is held only weakly accountable for its actions by a European Parliament with limited political powers. And, in a world with threats from terrorist networks and rogue governments, there will be a growing demand for an EU executive with the capacity to respond quickly to such dangers. But an EU executive with strong discretionary powers will be politically acceptable only if there exist

political institutions capable of holding him accountable for his actions. Although the EU will not become a federation anytime soon, it will have to develop a political framework that allows for some pooling of sovereignty. To the extent that similar pressures will be felt in other parts of the world, Europe's political experiment deserves to be closely watched.

2. What is Europe?

Economists like to start by defining terms. In the present context this means defining what we mean by Europe.

1. Europe as a geographic region. This is the definition offered by my Webster's Dictionary: "a continent of the eastern hemisphere between Asia and the Atlantic." It was the definition adopted by post-World War II policy makers, who described Europe as stretching from the Atlantic to the Urals.

Of course, this strictly geographic definition is arbitrary, especially when it is used to decide matters of policy. Why is Malta in but Turkey out when neither obviously meets Webster's geographical definition?³ Why is Poland in but Ukraine out? And what about the Western parts of Russia? The closer one looks at this strictly geographical definition of Europe, the harder it becomes to sustain.

2. Europe as a cultural identity. Europeans, it is sometimes argued, share a cultural heritage grounded in the Renaissance and the Reformation and manifested in Enlightenment values of rationality, individualism, and tolerance. The majority speak Roman, Germanic or

³Actually, one can think of some obvious reasons, but these have more to do with other factors, such as size, than with geographic location.

Slavic languages derived from a single Indo-European parent. It is this common heritage that defines them as European.

Yet this cultural definition is increasingly contested and imprecise. Declining costs of mobility are rendering the residents of Europe increasingly diverse in ethnic, racial and religious terms, in turn making it harder to maintain that they share a common historical and cultural inheritance. Valéry Giscard d'Estaing, the President of the Constitutional Convention, recommended including in the draft constitution a reference to religious values; the Pope recommended a reference to God. They provoked a telling backlash on a continent where church attendance is lower than in the United States and Islam is the fastest growing religion.

The same ambiguities apply to political as to ethnic and religious identity. When U.S. citizens travel abroad and someone asks us where we are from, most of us probably respond that we are Americans. Our counterparts on the other side of the Atlantic, notwithstanding their shared heritage and history, are more likely to describe themselves as, say, Spanish than European – or, for that matter, as Catalan or Basque.

3. Europe as an economic model. Others would distinguish Europe from, inter alia, the United States by pointing to its economic model. Europeans prefer a different point on the labor-leisure tradeoff; they work shorter weeks and take longer vacations. They enjoy greater job security. They resist high-powered incentives for executives that lead to large disparities in wages and incomes.

This absence of high-powered market incentives forces Europe to organize its economy in different ways. In Europe's "coordinated economy," firms depend more on nonmarket relationships to coordinate their endeavors and to construct their core competencies. These

nonmarket relations in turn are grounded in informal rules and understandings that derive from Europe's shared culture and history.⁴ As it is sometimes put, the resulting social market economy is less cut-throat and more civilized.

Of course, if Europeans no longer share a common culture and identity, then it is hard to insist that these provide a basis for their economic model. Even more fundamentally, it remains to be seen whether Europe is capable of sustaining a distinct economic model – a more civilized form of capitalism – in the face of competition from, inter alia, the United States and China. Some observers argue that, under pressure from globalization, the European economy is being remade along “Anglo-Saxon” lines. The only alternative, in this view, is to turn the continent into an open-air theme park whose only products of economic value are expensive wine, fine food, and sophisticated couture.

4. Europe as a single market. This is the definition that flows from the history of the European Community. The first concrete achievement of the six founding members of today's European Union was the European Coal and Steel Community (a single if not exactly free market in the goods of those industries), ratified by treaty in 1952. The ECSC was followed by the Treaty of Rome, which committed the same six countries to create a customs union, an achievement that was accomplished ahead of schedule by the mid 1960s. The capstone was the Single European Act of 1986, whose signatories committed to establishing by 1992 a unified internal market in not just goods and services but also capital and labor flows, thereby enabling the continent to exploit the economies of scale and scope available to continental economies such as the United States.

⁴The language and concepts here are drawn from Hall and Soskice (2001).

5. Europe as a monetary union. Europe is the only major region that has been able to create a monetary union on a continental scale. This singular achievement makes it the envy of policy makers throughout Latin America and Asia. It involves the sharing of important macroeconomic policy prerogatives. It entails the creation of truly transnational institutions like the ECB. And it has important symbolic value. Traditionally, the currency ranks right up there with the flag and the national airline as a symbol of the state. That Europe has its own currency suggests that it is acquiring the status of a political entity.

This in turn suggests a sixth and final definition.

6. Europe as a political project. To be part of Europe means to be a democratic society with free elections and respect for human rights. That they were not political democracies explains why Spain, Portugal and Greece were first excluded from the European Community, and their transition to democracy explains why they were welcomed in when they were. As a precondition for entry, the 10 soon-to-be new members, the so-called accession economies, were required to accept the *acquis communautaire*, of which democracy and respect for human rights are integral chapters.⁵

The EU, for its part, seems to be groping towards a new notion of sovereignty in which at least some traditional prerogatives of nation states are pooled or shared. While the prerogative of running a distinct national monetary policy is a case in point, it is not alone. The European Commission as regulator has the power to override national regulatory authorities. The European Court of Justice has the power to override national laws. And the Constitutional Convention,

⁵Similarly, questions about political openness and human rights are one reason (among several) why there is reluctance to initiate accession negotiations with Turkey.

while not exactly seeking to create a European federation, is attempting to design an institutional framework in which some political functions are carried out at the EU level while others devolve to national and subnational authorities. The result will not be a federal government as in the United States, at least in our lifetimes, but it will be some form of closer political integration. Again, Europe's solution to the problem of how to share national sovereignty without destroying it will contain important lessons for other regions.

Conclusion. Which of these definitions is most useful for our purposes? In fact, none suffices by itself for capturing what we mean by Europe. This one way of understanding why there is so much confusion about the direction Europe should take in constructing its future.

3. Economic Integration⁶

In its nearly 50 year history, the EU has gone a long way in removing barriers to flows of goods, services, capital and labor and harmonizing institutional arrangements for those flows. Inevitably, the creation of this economic space has raised concerns about the adequacy and efficiency of national approaches to economic regulation. For example, if the market in which firms compete is now Europe, not the nation state, mustn't competition policy be formulated and executed at the European, not the national, level? If footloose factors of production can move from high- to low-tax jurisdictions, shouldn't tax rates be set at the European level or at least be closely coordinated by national governments?

This point may seem obvious, but it has given rise to no end of confusion. In recent months we have seen initiatives to transfer significant responsibility over competition policy

⁶This section relies on Berglof et al. (2003).

from the European Commission in Brussels, where it currently resides, to national governments. Simultaneously we have heard suggestions that the framers of Europe's constitution embrace the principle that tax policy should be a competence of the European Union. Can these moves in opposite directions – in the first case devolution from Brussels to national capitals, and in the second case concentrating additional responsibility at the bureaucratic center – be logically consistent?

In fact, they are consistent but not logical. What they are is consistently wrong. They are wrong because they are not adequately grounded in the relevant body of analysis, namely, the theory of fiscal federalism. This theory identifies the criteria that should be used to assign responsibility for public functions to different levels of government.⁷ Its starting point is the assumption that each government cares only about the welfare of its own constituents, and that conflicts arise because those constituencies are not the same.⁸ Only the central government takes full account of the welfare of all individuals irrespective of where they live.

Consider the implications for the provision of public goods, a key task of government. Because public goods are nonexcludable (I cannot prevent you from also deriving satisfaction from my spending on them), there is an incentive to free ride, that is, to under-invest in provision (since each individual benefits from the provision of public goods by others). Tasking the government with public good provision internalizes this externality.

The question for present purposes is what level of government. The theory of fiscal

⁷See Oates (1999) for a survey of this literature.

⁸This strong assumption can of course be relaxed. What matters is that each government cares most about its own citizens.

federalism provides a simple answer. When spillovers across jurisdictions are pronounced, public goods should be provided either by the central government or through close coordination among subcentral governments. Under centralized provision, local governments lose their ability to free ride, but local control is foregone. (They have no ability to tailor public goods and services to local conditions and preferences.) Thus, centralized provision is preferable when under-provision is costly but preferences are homogenous. In contrast, coordination among governments that falls short of the transfer of control to a central authority will not fully solve the free-rider problem, given the difficulty of monitoring and enforcing compliance, but it will allow local authorities to tailor provision to local conditions and preferences. It will be preferable when those conditions and preferences are heterogeneous.

This simple framework can be used to analyze the allocation of tasks to different levels of government.

1. The single market. Ensuring that member states do not place barriers in the way of the single market is an obvious responsibility of the European Union. Preferences toward the single market are uniform (it receives strong support in all member states), and spillovers are pronounced (any member state that uses government procurement policies, product standards, or prudential regulations to restrict access to its market imposes a cost on other member states). That delimiting the use of such policies is a competence of the European Commission, the EU's central technocracy in Brussels, has been acknowledged by the European Parliament (2002).

Similarly, there is no scope for national tariff policies in an integrated market; if European countries applied different tariffs, imports would be funneled through the low-tariff country and transshipped to its high-tariff neighbors. Again, there is no dispute that

responsibility for EU trade policy is a competence of the Commission; the commissioner for trade policy, currently Pascal Lamy, is designated this responsibility.

2. Competition policy. That Europe is a single market, which defines the economic space over which competition takes place, suggests that competition policy should be a competence of the Union. This is how we organize things in the United States, where competition policy is the responsibility of, among others, the U.S. Department of Justice.

Not surprisingly, the commissioner for competition policy is a prominent member of the European Commission. More surprising is that the Commission has recently proposed decentralizing the responsibility for enforcing the EU's competition rules to the national anti-trust authorities. The rationale is that national market conditions are so complex and differentiated that it is hard for a centralized bureaucracy to know how to effectively enforce the EU's competition rules and directives.⁹ The idea is that the competition commissioner and national anti-trust authorities should form a network, with the former taking the lead in setting standards but the latter taking the lead in enforcing them.

But while this is a broadly sensible arrangement, given the difficulties a centralized authority is likely to have in sorting through complex local market arrangements, it creates a danger of free riding. National anti-trust authorities may be inclined to ignore the existence of a dominant firm if the national champion enjoying it can leverage its position into the acquisition of additional market share in other countries. There is also a question of administrative capacity, especially in the accession economies, whose governments have little experience of anti-trust

⁹In terms of the theory of fiscal federalism, we can think of this as decentralization justified on grounds of heterogeneity of local conditions, in this case of conditions affecting enforcement.

enforcement. U.S. practice, where federal and state attorneys general share responsibility for product market regulation – state attorneys general enforce state laws, the federal attorney general enforces federal law – suggests that the status quo may be preferable to further devolution.

3. Prudential supervision and regulation. Supervision and regulation of the financial system is a difficult case, because while spillovers are pronounced so is the heterogeneity of local conditions. Problems in one national banking system can infect the banking systems of other countries, increasingly so as banking systems are linked not just by the interbank market but as mergers and acquisitions allow banks to branch across borders. This creates an argument for centralizing the supervisory function. At the same time, local supervisors have more knowledge and experience with local markets and a comparative advantage in gathering information about the condition of local financial institutions. Financial systems are heterogeneous: banks play different roles in different countries, and regulation is organized in different ways. In some European countries, prudential supervision and regulation is the responsibility of the central bank, while in others it is assigned to an independent agency. This heterogeneity argues for decentralization.

The obvious solution is to network national supervisory agencies with their counterpart in Brussels. The EU supervisor would set supervisory standards, but the national authorities, which have a comparative advantage in assembling and processing information, would be responsible for enforcement. There would then be no reason to insist that those national authorities be structured and organized in uniform ways. Devolving responsibility for gathering information and enforcing regulations is less likely to create free rider problems than in the case of

competition policy, since in this case lax enforcement works to the disadvantage of the subject country as well as its neighbors. To the extent that under-enforcement remains a problem, the EU regulator can offset it by setting more stringent capital and liquidity standards.

These conclusions are consistent with the recommendations of the Lamfalussy Report, which argued for an expanded role for EU institutions in supervision and regulation.¹⁰ To date, however, its recommendations have been resisted by national governments, who worry that the partial transfer of supervisory authority to Brussels will diminish their prerogatives. A perspective grounded in the theory of fiscal federalism suggests that their resistance is misplaced.

4. Tax policy. Currently, the power to tax resides almost entirely with national and local governments. While value added taxes are harmonized, other taxes are set unilaterally by member states. The proponents of additional centralization, including some delegates to the convention, argue that tax harmonization is necessary in order to avoid interfering with the operation of the single market. They warn that factors of production will move to where tax rates are lowest, giving national governments an incentive to engage in destructive tax competition that robs public programs of funding and shifts the burden of taxation onto mobile factors like labor and away from more immobile factors like capital.

In fact, there is evidence that tax competition has worked to shift the burden of taxation onto immobile factors of production. Reflecting the relatively high mobility of capital, Europe's corporate tax rates have declined and converged, while rates of labor taxation have remained

¹⁰They are also consistent with the Commission's Financial Services Action Plan, and of the joint German-British proposal for an independent committee of regulators at the EU level.

relatively high.¹¹ To the extent that European labor markets are also plagued by other distortions, resulting in high labor costs and high unemployment, saddling this market with a large “tax wedge” only compounds the problem.

But while financial capital is highly mobile, physical capital is not. Tax rates are only one of several factors shaping the decision of manufacturing companies of where to locate their assembly plants, as we know from the experience of the United States. While states compete aggressively with tax concessions and holidays to attract manufacturing plants, this does not result in the relocation of all U.S. manufacturing to South Carolina. And if it limits the tendency for governments to become overlarge, then a little tax competition is welcome. International comparisons do not suggest that Europe’s public sector is stunted by the difficulty of funding public programs. In addition, different European governments have different views of the appropriate size and structure of the public sector. This heterogeneity of preferences remains an important reason to oppose the centralization of taxation.

All this suggests, contrary to some discussions at the convention, that taxation should remain a competence of national governments. Sales and financial transaction taxes, where cross border shopping and the high mobility of financial capital render spillovers exceptionally large, may be exceptions. But, otherwise, the case for shifting this responsibility to the European level of government is not strong.

5. Labor markets. The single market implies an intensification of cross-border competition. In principle, this makes it more costly for individual countries to maintain restrictive labor-market practices – high minimum wages, limited hours, long mandated

¹¹The evidence to this effect for the 1990s is unambiguous; see Berglof (2003).

vacations – insofar as high labor costs will cause them to lose jobs to their less generous neighbors. The fear is that this will cause a race to the bottom, undermining the social market economy and the welfare state. Preventing this, it is said, requires the centralization of labor market regulation or at least close coordination by national regulators. This is one justification for the European social charter (signed in 1961, revised in 1996, and entered into law in revised form in 1999), which defines minimum standards for labor markets in EU member states.¹²

But here, again, the idea that decentralization will lead immediately to a destructive race to the bottom is exaggerated. While the single market has already resulted in a significant intensification of cross-border competition, it has not forced the welfare state to be dismantled. Labor mobility and job relocation are still limited by cultural and linguistic differences across countries. And, to the extent that political distortions have created a welfare state that is too lavish and labor market regulations that are too costly, a little additional competition, as in the area of taxation, is not entirely bad.

Also working against the centralization of labor market regulation is the heterogeneity of conditions and preferences. There are pronounced differences between, say, Germany and the UK in what are regarded as appropriate levels of worker protection. Labor productivity differs sharply across European countries, and these differentials will become even more pronounced with enlargement. Already there are worries that the social charter and the *acquis communautaire* will impose a costly burden on the EU's new, relatively low productivity Eastern European members. All this suggests that the present approach, which defines labor standards loosely and

¹²The social charter gives workers the right to fair remuneration, a safe and healthy workplace, and rights to protection in the event of termination of employment, among other things.

leaves room for differential implementation at the national level, is approximately right.

6. Redistribution. Redistribution is economically efficient when individuals are altruistic or utility functions are otherwise interdependent. It will also be in the interest of the donor when it induces changes in the behavior of the recipient from which the donor benefits directly.

It is hard to defend the Common Agricultural Policy (CAP) and Structural and Cohesion Funds (SCF), the two programs through which intra-EU redistribution is undertaken, on these grounds.¹³ The citizens of France evidently care about the economic condition of French farmers, but it is hard to imagine that Germans and Poles are happier when French farmers receive higher incomes as a result of price supports and export subsidies. While national political systems may, in their wisdom, redistribute resources from the consumers to the producers of agricultural goods, there is little justification for one country's consumers to support another's farmers. This suggests returning this redistributive program to national governments.

Of course, if redistribution is to occur within countries, it must not interfere with the operation of the single market. Hence, if responsibility for agricultural policy is returned to the national level, it must still be subject to standards and restrictions on implementation imposed by the EU (as with any policy affecting international competition). The obvious way of squaring this circle is by replacing price supports, which are distortionary, with lump-sum transfers to farmers. To the extent that the French value farming for environmental-beautification reasons,

¹³Hayo (2003) mounts a luke-warm defense, showing that contributions to the EU budget increase more than proportionately with relative GDP and expenditures on countries increase more than proportionately with relative need, although in order to make the latter argument he must take the importance of the agricultural sector as a proxy for relative need.

those payments might be linked to rural beautification projects.

That there has not been more progress in this direction reflects the politics of self interest. France, the main recipient of net transfers through the CAP, has opposed the conversion of price supports to lump-sum payments for fear that this will lead to a diminution of its net transfer receipts over time. There is no broader economic rationale for its position.

The Structural and Cohesion Funds were adopted for two reasons. First, there was the fear that the poor countries could not compete head to head with their more advanced neighbors; in the absence of transfers to finance, *inter alia*, improvements in physical infrastructure, they would fall further and further behind, threatening the political cohesion of the Union. Second, in the absence of such transfers, there was the specter of large-scale migration from the low-income countries, imposing undesirable externalities on their high-income counterparts.

Both fears turned out to be unfounded. The low-income countries have actually been the largest beneficiaries of European integration. They have grown the fastest, and their tendency to gain ground has been reinforced by integration (Eichengreen and Ghironi 2002). Moreover, there is little evidence that Structural Fund transfers have stimulated faster convergence. And migration from Greece, Spain and Portugal turned out to be more limited than initially feared.

Already there has been some tendency to scale back the SCF on the grounds that it will be too expensive to maintain transfers on the current scale once the EU is enlarged to include an additional 10 low-income members. This should be taken an opportunity to push for an even more radical reduction in the Structural and Cohesion Funds, not on the grounds that redistribution is undesirable, but that it is a task for national governments, not the European Union, at least until European solidarity and identity become more pronounced.

7. Stabilization. In a monetary union like Europe's, where the same monetary policy prevails over the entire continent, fiscal policy is the remaining tool for cushioning economies against country-specific shocks.¹⁴ There is a considerable literature, starting with Bayoumi and Eichengreen (1993), suggesting that country-specific shocks are more prevalent in Europe than in the United States.¹⁵ This heterogeneity of conditions argues for assigning fiscal policy to national governments, which can formulate it with their national circumstances in mind. This argument is stronger for Europe than the United States, where the federal tax and transfer system works to transfer resources between booming and depressed regions, doing much of the work that must be done by national fiscal policies in Europe.

Pointing in the other direction, to the need to coordinate fiscal policies, are arguments about cross-border spillovers. Spillovers can be positive if fiscal expansions in recessions are felt in other countries as additional demand for their exports. They can be negative if fiscal expansions are felt in the form of higher interest rates not just at home but also abroad. European policy makers also worry that chronic deficits in some member states will impose inflationary costs on their neighbors and that, since the predominance of costs is not borne by the citizens of the fiscally irresponsible state, there will be a bias toward excessive deficits. The mechanism they have in mind is a debt crisis that applies pressure to the ECB to extend an inflationary debt bailout in order to keep the offending member state's debt problems from infecting the rest of the monetary union.

¹⁴To be sure, "entire" continent is an exaggeration, given that not all countries are yet participants in the monetary union, but it is a useful shorthand.

¹⁵Although there is of course the question of whether the elimination of country-specific shocks emanating from national monetary policies has significantly transformed this picture.

These concerns have led to the development of the Stability and Growth Pact (SGP), a procedure for conducting surveillance of national fiscal policies and imposing sanctions, including possibly fines, on countries that do not accept and act upon the recommendations of the Commission and the Council. The SGP is designed to leave room for national governments to tailor their fiscal policies to national conditions but also to provide incentives for budgetary coordination (that is, for countries to internalize the effects of cross-border spillovers) and sanctions against countries whose excessive debts and deficits threaten price and financial stability. Countries are free to run deficits up to 3 per cent of GDP. If their budgets are close to balance or in surplus in normal times, this offers room for their automatic stabilizers to work. All the while, however, governments must submit convergence programs (detailing their multi-year fiscal plans) and participate in surveillance exercises designed to encourage them to take cross-border spillovers into account. When deficits exceed 3 per cent of GDP (except in the event of serious recessions), the Excessive Deficit Procedure may be activated, leading to warnings, non-interest-bearing deposits, and ultimately fines.

Thus, the SGP is designed to strike precisely the balance that the theory of fiscal federalism would deem appropriate. Why then is it so controversial?

- First, empirical studies have determined that the cross-border spillovers of fiscal policy are limited. They show that the cross-border impact on exports and interest rates is modest, even ambiguous in sign.¹⁶ From this point of view, the SGP is a solution out of

¹⁶Think about the fact that European countries are integrated not just with one another but also with the rest of the world. Germany may have to suck in foreign funds to finance its deficit, driving up interest rates abroad, but it can obtain that external finance worldwide, not just from other European countries, given the existence of a global capital market. The same basic point applies in the case of stimulus to foreign exports.

proportion to the problem. And if the goal is really to coordinate fiscal policies on an ongoing basis, then a strict 3 per cent ceiling on deficits is not obviously a suitable tool for achieving this end.

- Similarly, there is reason to doubt that a debt crisis in one European country would seriously destabilize neighboring financial markets and force the ECB to extend a debt bailout with seriously inflationary consequences. It is not obvious that one country's default would demoralize another's financial markets; surely investors are capable of distinguishing British and Italian government bonds, just as they can distinguish the debts of Argentina and Mexico. And even if the ECB felt obliged to intervene, injecting liquidity into the financial system in order to backstop securities markets, it could unwind those purchases subsequently, eliminating their inflationary consequences.¹⁷
- Finally, European governments (those of France, Germany, Italy and Portugal prominent among them) have not succeeded in maintaining budgets close to balance in normal times, leaving their automatic stabilizers hamstrung in slowdowns. The flaw in the SGP from this point of view is that it applies too little pressure for fiscal adjustment in good times and too much pressure for consolidation in bad times. Thus, while the benefits of the procedure are questionable, the costs can be high (as we are seeing in the current slowdown).

Numerous proposals have been tabled for reforming the SGP, ranging from abolishing the pact at one extreme to making it more stringent on the other. The theory of fiscal federalism

¹⁷This is what the Fed did in 1998, in the wake of the all-but-failure of Long-Term Capital Management, with no obvious inflationary fallout.

suggests that neither extreme is optimal. The macroeconomic spillovers of uncoordinated fiscal policies may not be pronounced, but some spillovers there surely are; eliminating all mutual surveillance of national fiscal policies is therefore not the best way to go. But national conditions do differ; hence a strictly enforced 3 per cent ceiling for deficits that takes no account of this fact would also be suboptimal.

What is needed is a reformed pact that focuses on the source of cross-border spillovers while leaving room for automatic stabilizers to work. Assuming that aggregate demand spillovers are limited and can be better internalized by strengthening the surveillance process (along the line suggested by Benoit and Pisani-Ferry 2003), the remaining problem is that of unsustainable debts. It can be better addressed by focusing the pact on debts rather than deficits; after all, if a country has a low debt, it can run deficits for many years before the resulting debt becomes unsustainable.

Thus, Pisani-Ferry (2002) suggests dropping the 3 per cent reference value for deficits and focusing instead on the 60 per cent reference value for debts; countries whose debts are below this threshold would be free to run the fiscal policies they prefer. Unfortunately, the 60 per cent threshold, which first appeared ten years ago in a protocol to the Maastricht Treaty, is not well grounded in economic logic.¹⁸ Governments will always be able to say that their circumstances are special – that the 60 per cent ratio does not apply to them. The accession economies can argue that scope for catch-up will permit them to grow more rapidly than the

¹⁸Buiter, Corsetti and Pesenti (1993) note that 60 per cent was in fact the EU-wide debt/GDP ratio in 1992, when the Maastricht Treaty was ratified, and that a deficit/GDP ratio of 3 per cent stabilizes a net debt/GDP ratio of 60 per cent when nominal income growth is 5 per cent (close to the 1980s and 1990s norm in Europe). But while this is a possible explanation for how officials settled on this number, it is not an economic justification for its continued use.

long-time EU members for whom the 60 per cent ratio was designed; if the denominator of the debt/income ratio is rising faster, other things equal, a given ratio will be less of a problem. More generally, because the number is arbitrary (no one really believes that a debt ratio of 59 per cent is sustainable whereas 61 per cent is not), it will not be taken seriously. Because it lacks a clear rationale, it will not be regarded as legitimate. And if it is not legitimate, it will not be enforceable.

In addition, the Pisani-Ferry alternative does poorly in applying pressure for fiscal adjustment in good times. Dropping the 3 per cent deficit target and concentrating on the 60 debt target would apply no pressure at all to countries whose debts were low. Responding to this concern, Benoit and Pisani-Ferry (2003) recommend that the Commission should conduct annual sustainability assessments and produce concrete targets for the government deficit (appropriately adjusted for the economic cycle). They argue that these surveillance exercises would require countries to reduce debts and deficits in good times. In practice, the premise is dubious. In good times countries will be able to point to the fact that the denominator of the debt/income ratio is rising and argue that there is little need for adjustment on sustainability grounds. It is hard to imagine that the Commission, which is not independent of politics, would be able to demand even larger surpluses of surplus countries in expansions, and that it would be able to impose heavy fines on those that fail to comply.

The essential rationale for the Stability Pact is that deficits today may be a leading indicator of deficits tomorrow and therefore of unsustainable debts.¹⁹ Transitory deficits in recessions are part of the solution, not part of the problem; they simply reflect the operation of

¹⁹And that chronic deficits will force the ECB to provide an inflationary debt bailout.

automatic stabilizers. My preferred alternative is therefore to focus on the sources of chronic deficits.

But what are these sources? Deficits are likely to be chronic when countries fail to reform their fiscal institutions. Countries with large unfunded pension systems will almost certainly have deficits down the road. Where workers are allowed to draw unemployment and disability benefits at will for indefinite periods, deficits today signal deficits tomorrow.

Countries that have not completed privatizing public enterprise are similarly more likely to find fiscal skeletons in the closet. Where decentralized decision making and revenue sharing allow states and municipalities to spend today and be bailed out by the central government tomorrow, the latter will inevitably suffer chronic deficits.

These observations are grounded in a large literature that concludes, almost without exception, that institutional arrangements are strongly and robustly associated with observed fiscal outcomes.²⁰ For example, the literature on Latin America shows that countries with large vertical fiscal imbalances are prone to chronic deficits; they allow states and provinces to spend now and be bailed out by the central government tomorrow.²¹ Where state governments have their own public banks, the latter tend to become lenders of last resort to the local authorities and engines of deficit spending and inflation. Where national budgetary institutions are more hierarchical, in contrast (where the president maintains a one-party majority in the parliament or where the number of veto players is small), deficit bias is less. Revealingly, countries are more

²⁰See von Hagen and Harden (1995), Fukasaku and Hausmann (1998), and von Hagen (1998).

²¹See Stein (1998). Readers will remember how the deficits of the provinces constituted a large part of Argentina's fiscal problem.

likely to have statutory caps on deficit spending, similar to the EU's 3 per cent rule, where vertical fiscal imbalances are large and budgeting processes are less hierarchical.²² Only countries with relatively decentralized budgetary institutions, large vertical fiscal imbalances, and open-ended spending programs -- countries which are prone to chronic overspending -- display a need for numerical rules.

The implication is that the Stability Pact should focus not on fiscal numbers, which are arbitrary and easily cooked, but on fiscal institutions. The Council of Ministers should agree on an index of institutional reform with, say, a point for pension reform, a point for unemployment and disability insurance reform, and a point for revenue sharing reform. Countries receiving three points would be exempt from the Stability Pact's guidelines, since there is no reason to expect that they will be prone to chronic deficits. The others, whose weak institutions render them susceptible to chronic deficits, would in contrast still be subject to the pact's warnings, sanctions, and fines.

An additional strength of this proposal is that it would presumably result in more fiscal adjustment in good times. Countries with stronger institutions that enable them to internalize common pool and free rider problems in budgeting should have stronger fiscal positions in good times as well as bad.

While many questions can be raised about the details of this proposal, the central point is beyond question, namely, that a sensible reform should focus on the source of the problem, not

²²As documented in von Hagen and Eichengreen (1996).

on symptoms of questionable relevance.²³ Reform of the SGP should be guided by the theory of fiscal federalism, which suggests balancing the advantages of central control against those of tailoring national fiscal policies to distinctive national conditions. It does not suggest that responsibility for European fiscal policies should be transferred to the Commission and the Council; if the power to tax is the defining characteristic of a government, it does not suggest that an EU superstate will assume the prerogatives of Europe's national governments anytime soon. But neither does it suggest that the EU should abrogate all responsibility and that control of national fiscal policies should be returned to national governments. In the Europe of the future, this responsibility will continue to be shared.

Conclusion. Thus, the argument that economic integration is leading inevitably to the creation of a super-government in Brussels that will eventually assume the significant prerogatives of the governments of member states is unlikely to be correct. Tradeoffs are involved. In this case, the tradeoff is between the efficiency advantages of centralization, which are strong where spillovers are pronounced, and the efficiency advantages of decentralization, which dominate when preferences and practices are heterogeneous. There may indeed be some tendency toward additional centralization as market integration renders cross-border spillovers even more pronounced and as Europeans grow increasingly mobile, reducing the heterogeneity of local preferences and practices. But, for the time being, there remain strong justifications for decentralization in a variety of issue areas. The idea that the single market will lead inevitably to the emergence of a European super-state is without foundation.

²³There is no space to even pose them here. I ask and answer the most important such questions in Eichengreen (2003).

4. Monetary Integration

The euro is one of Europe's most striking achievements. To be sure, the single currency has not solved all of Europe's problems; slow growing countries like Germany that would prefer a looser monetary policy may indeed feel that it has created more problems than it solved. But a more systematic accounting would entail including also a number of additional factors on the credit side of the balance sheet. By eliminating currency conversion costs and enhancing price transparency, the euro has further enhanced the operation of the single market; this is evident in the sharp increase in the share of their trade that Germany and France now conduct with one another. The euro has eliminated problems of exchange rate instability within Europe; had the countries in which it now circulates still been attempting to hold their national currencies within 15 per cent bands against one another, one can well imagine that the events of 9/11, the fall in the dollar, or other shocks to the world economy could have given rise to severe exchange rate strains and even crises of the 1992-3 variety. The elimination of currency risk has also stimulated the development of a more liquid bond market, enhancing the market access of European corporations, including some with sub-investment-grade ratings. This has given the continent a better diversified financial system and provided valuable liquidity with which to finance mergers, acquisitions, and reorganizations.

This is not to deny the existence of significant criticism the ECB, its policy choices, its operating procedures, and its organization. Many of these criticisms are technical in nature, which may itself be indicative of the fact that the ECB is now widely accepted. Since there is basically no disagreement over whether the ECB should exist, the critics can focus – as they do

in the case of other central banks such as the Fed – on specific policy decisions and procedures. At the same time, some of these issues, such as how the Executive Board should be constituted, again raise questions about the nature of the Europe to which the ECB provides monetary services.

1. Targets and Strategies. The ECB has a target ceiling for inflation of 2 per cent and a two-pillar strategy of monitoring both the inflationary pressures and the growth of the monetary aggregates. A 2 per cent ceiling for inflation is more ambitious than the targets of other central banks. Some have warned that such a low ceiling may be ill advised. For one thing, published figures for inflation overestimate the extent of the phenomenon by incompletely capturing quality improvement.²⁴ A more serious problem is that if the target is undershot and deflation sets in, it may then be very hard to reverse. This is a lesson of Japanese experience: a deflationary trap is easier to enter than to escape. Expectations of deflation may become self-fulfilling as the normal instruments of monetary policy are rendered ineffectual by the liquidity trap. The Fed seems to have concluded that it is better to act preemptively – to expand aggressively before the threat of deflation becomes imminent.

The problem is that the ECB's very low inflation target may lull monetary policy makers into complacency. It may suggest that monetary policy is on target when in fact there is a small but potentially very costly risk of deflation. There may have been some rationale for a stringent 2 per cent ceiling at the outset, when there still could be questions about the depth of the ECB's anti-inflationary commitment. But now that this has been established, a more generous target,

²⁴Actual inflation may be one to two per cent less per annum than suggested by the official estimates.

perhaps with a range of 1 to 3 per cent – and thus a positive lower bound – would be more prudent.

The need to establish a credible commitment to price stability also explains why the ECB adopted the two-pillar strategy of targeting both inflation and monetary aggregates. The German Bundesbank long claimed that it targeted the money stock, although in practice it paid it more lip service than actual attention. What better way to establish credibility, the founders of the ECB presumably thought, than to emulate the Buba? Unfortunately, the monetary aggregates bear no stable relationship to future inflation when inflation is low; there are simply too many intervening variables.²⁵ This is why even the Bundesbank honored its money supply targets mainly in the breach. In the case of a central bank like the ECB with a very limited track record, arguing one thing and doing another is not credibility enhancing – to the contrary. Claiming to formulate policy on the basis of an indicator of dubious relevance does more to diminish credibility than to enhance it. Now, when the two-pillar strategy is evidently under review, would be a good time to do away with the monetary target.

2. Transparency. Unlike the Fed, the ECB does not publish its minutes. Unlike the Bank of England, it does not reveal its board members' votes. It does not release the inflation forecast on whose basis its decisions are based in part, nor does it describe the model used to link its policy instruments to their targets. Arguably, this opacity sows uncertainty and confusion about the central bank's objectives. It slows the development of monetary policy credibility by not providing a clear rationale for the central bank's actions.

²⁵At high inflation rates, in contrast, the money stock has more information content, as shown in Begg et al. (2003).

The ECB has justified its refusal to be more transparent by pointing to other central banks, like the Fed, which have been able to justify their policies without publishing an inflation forecast or purporting to explain how a particular level of interest rates will translate into a specific inflation rate many months down the road.²⁶ Indeed, publishing inflation forecasts might create a spurious sense of precision. Inevitably that forecast would prove wrong, in which case publication might do more to damage credibility than to establish it.²⁷

The ECB has argued that releasing the minutes of board meetings and the votes of members would intensify the pressure for individuals to vote in accordance with the preferences of their national governments. Politicians would learn whether board members were acquiescing in policies that diminished their reelection prospects. Newspaper coverage of their votes might darken board members' post-public service employment prospects, again influencing their decisions.

Whatever the validity of these arguments, there is a compelling counter-argument, namely that given Europe's current political structure, transparency is a key mechanism holding the ECB accountable for its actions. Normally, the president and board of a national central bank are held accountable for their decisions by the national parliament or congress, which is privy to unusually detailed information about its policy decisions. If the central bankers insist on pursuing policies that are perceived as contrary to the national interest, politicians can make their lives very difficult. In the limit, they can revoke the statute that guarantees the central bank its

²⁶See for example Issing (2002).

²⁷Of course, this assumes that market participants are unable attach confidence intervals to the central bank's inflation forecasts, and that the central bank is unable to attach these itself.

independence.

In the European Union, in contrast, there is no political body to hold the ECB accountable. The European Parliament has little real power and is privy to little private information about the conduct of monetary policy. The independence of the ECB is guaranteed by an international treaty that can be amended only with the consent of each and every member state. Consequently, the only place where the ECB can effectively be held accountable for its actions is the court of public opinion. And for public opinion to be effective, it must be informed. This is an argument for why the ECB should be even more transparent than other central banks.

3. Should the outs come in? The question of whether the UK, Sweden and Denmark, which have so far remained outside the euro zone, should now come in will come to a head with publication by the UK Treasury of its analysis of the Chancellor's five tests and Sweden's referendum. Let me suggest the economic considerations on which their decisions should turn. As a convenient shorthand for their common dilemma, I will refer to the UK case.²⁸

Surely the UK will reap more benefits from adopting the euro if it can shape the institutions of the Euro Zone to its liking. It might seem self evident that it will be better able to influence the structure of those institutions as an In than as an Out. In reality, however, things are not so simple. A systematic analysis would seem to require distinguishing three considerations.

- First, a country staying out of the eurozone faces an externality from the behaviour of the

²⁸This analysis was developed for purposes of Begg et al. (2003), with the help of Paul Seabright in particular.

Ins. In the literature on cartels, this externality is typically positive (the Out enjoys higher prices because the members of the cartel restrict output). In the present case, however, the externality may be either positive or negative. It will be positive if trade creation within the eurozone induces greater trade with the UK, but may be negative if greater competition within the eurozone places the UK at a disadvantage or if eurozone institutions unnecessarily hamper eurozone growth, which then becomes a drag on the UK economy. I label this externality channel as Channel A.

- Second, entering the coalition has both costs and a benefits. Most obviously there are direct, once-off changeover costs from adopting the new currency. More importantly, there is the adverse effect of being directly subject to flawed eurozone institutions, rather than merely suffering their consequences at one remove (through Channel A). Finally, there is the benefit of greater trade creation as an In than an Out. I label these direct net costs as Channel B.
- Finally, entering the coalition enhances the agent's ability to influence the decisions of the coalition. I label this benefit Channel C.

If the benefit C exceeds the net cost (B-A), then entering is rational. The net cost (B-A) almost certainly rises with the deficiencies of eurozone institutional design; that is, defects in ECB monetary policy or the Stability and Growth Pact have larger effects on Ins than Outs. Conversely, (B-A) is lower the greater are the gains from trade creation and other benefits that accrue only to members the eurozone.

As an Out, the UK experiences A in any case. However, the larger the net costs B that the UK would incur as a eurozone member (for example, the greater the problems from the UK's

point of view of the eurozone's institutional arrangements), the more the UK, if it decided to enter, would have to be confident that it could count on benefits C from forcing through institutional reforms.

Could the Outs exert much political leverage on institutional reform within the EU? What is the likely magnitude of Channel C, in other words? Countries like the UK can influence eurozone reform through power of example – as an Out – as well as through power of participation – as an In.²⁹ The UK can encourage the ECB to adopt inflation targeting by demonstrating the superiority of the Bank of England's operating procedures, as well as by becoming a voting member of the ECB and lobbying for changes in its operating procedures. It can encourage reform of the Stability and Growth Pact by staying outside and demonstrating the superiority of its Code for Fiscal Stability or by entering and insisting on changes.

History suggests that Ins have significantly greater leverage than Outs over the initial design of EU institutions but not thereafter.³⁰ Does this mean that it is already too late for the

²⁹In Hirschman's famous terminology, this is the distinction between exit (or, in the present context, refusal to enter) and voice.

³⁰For example, as a full EU member the UK is present at the bargaining table for discussions of reform of the Common Agricultural Policy. Crucially, it was not at the table when the basic CAP parameters were first hammered out between the 6 founder members of the EEC. Yet those parameters continue to constrain sharply the options for reform. Arguably, as an EU-In, Britain's influence over CAP reform is no larger than that of the United States, an EU-Out. Similarly, EU competition policy was shaped in the 1960s by French and German practice. As a late EU entrant, the UK has been fighting an uphill battle ever since: only two decades after UK entry did EU competition policy begin to be reformed along Anglo-American lines, and arguably American influence has recently been more important than that of the UK. A third example is the Single Market programme. As late as 1986, it was unclear whether the single market would deliver the chill winds of competition to the European economy or provide insulation for the European Social Model against competitive pressures emanating from outside. At this bargaining table at the outset, the UK had additional leverage over the design of the single market, helping shape it as a vehicle of competition rather than a Fortress Europe. Indeed the Cockfield Report, which set out the framework for the Single Market and the Single European

UK, Sweden and Denmark to influence monetary and financial arrangements in the eurozone? Perhaps not, to the extent that eurozone institutions are still in flux. The next few years offer a key window in which this institutional architecture will be refined; thereafter, it is likely to be set in stone, loosely speaking. And there is a clear date by which this window is likely to be shut again: incumbent member states will want the job done before the new accession countries enter the eurozone, which might be as early as 2006-7 (as I now explain).

4. When will the accession economies join? The EU has agreed to take in eight new Eastern European members together with Malta and Cyprus as early as 2004. Warnings have been sounded that these countries should not rush to adopt the euro. Little more than a decade into the adjustment to the market, their economic structures are still evolving. Economic conditions that differ from those in Western Europe's mature market economies imply asymmetric shocks, a classic justification for independent monetary policies. The prospect of rapid growth means additional Balassa-Samuelson inflation and therefore the desirability of tighter monetary policy than in the West.

These are all reasons for thinking that the accession economies may find it uncomfortable to subject themselves to a monetary policy run by a central bank dominated by mature Western European economies. But the alternatives may be even less comfortable. Floating is problematic for countries that trade heavily with Western Europe and borrow externally in euros; this last fact, in particular, suggests that currency fluctuations could have destabilizing balance sheet effects. While attempting to hold the currency within narrow bands would eliminate this last

Act that provided its political underpinnings, was chaired by the UK Commissioner Lord Cockfield.

danger, it would only substitute another, namely, that of speculative attacks.

One conceivable solution is to harden the peg by adopting a currency board or even to euroize unilaterally (that is, to make the euro legal tender even before the countries in question acquire seats on the ECB board). But the EU, in its wisdom, opposes unilateral euroization and has warned the accession economies that pursuing this option might jeopardize their candidacy for EMU. The currency board option remains open, but if the accession economies are going to import the euro-zone's monetary policy, they would presumably wish a voice in its formulation. Hence, they almost certainly will wish to join the euro zone at an early date.

There are a number of reasons to think that they are will succeed.

- Unlike Denmark and the UK, which were able to negotiate opt outs as a condition for agreeing to the Maastricht Treaty, the accession economies are obliged to accept existing EU treaty obligations. Hence they are obliged to prepare for monetary union and to enter as soon as deemed ready by their partners.
- The accession economies come as close as existing EMU members to satisfying the optimum currency area criteria. They are small and open. They trade disproportionately with the EU. Many already have gone a good way toward establishing independent central banks. Some, like Estonia, have already demonstrated their ability to live with a monetary policy set by the European Central Bank, while most of the others already formulate their exchange rate policies with reference to the euro.
- The accession economies will have little trouble satisfying the convergence criteria that govern the entry decision. They inherited relatively light public debts from the pre-transition period and have limited non-inflationary options for financing deficits. Most

have relatively centralized fiscal institutions which give them the capacity to respond quickly to shocks.³¹ To be sure, they rate less favorably in terms of the inflation and interest-rate criteria. But experience suggests that these variables — interest rates especially — respond quickly to prospects for EMU membership.

- The incumbents are unlikely to succeed in keeping the aspirants out. The new EU member states will have blocking power in the Ecofin Council over a variety of matters requiring unanimous consent. They can use that power to slow progress on other matters if the incumbents attempt to delay EMU enlargement.³²
- Finally, a number of the accession economies have addressed problems in their financial systems by selling off their banks to Western European institutions. This limits the danger of a banking crisis that could derail efforts to meet the convergence criteria.

Together these arguments imply that the ECB should begin preparing now for a monetary union of anywhere from 20 to 25 members.

5. Internal reorganization. A decision making council with six executive board members, who speak for the eurozone as a whole, together with representatives of as many as 25 national central banks will quickly become unworkable. The U.S. Federal Open Market Committee has 12 voting members, while the Bank of England's and Bank of Japan's policy boards have nine. It will be difficult to build consensus and react quickly with such a large

³¹See Gleich (2003). Although Eastern European populations are aging, which will increase fiscal burdens related to pensions and health care, demographic change little faster than in the West. Complying with EU environmental standards will cost the prospective members at most one to two per cent of GDP.

³²The was the situation that led the Maastricht entry criteria to be interpreted flexibly in 1997 and for all 12 EU member states wishing to join the monetary union to be deemed qualified either immediately or within two years of the inauguration of Stage III.

board. An ECB that was slow to raise interest rates when inflation was accelerating or to cut them when growth was slowing, reflecting its inability to make quick decisions, would enjoy neither policy credibility nor political support, as became evident when the institution was slow to react to the economic slowdown in 2001.

At the Nice Summit, EU leaders took a first step toward reducing the number of members of the Governing Council, inserting into their draft treaty a clause allowing for changes in the ECB's decision-making procedures without the approval of an inter-governmental conference. Subsequent proposals included moving to a constituency system like that of the IMF, where countries are formed into groups, each with one representative; adopting a rotation system like that successfully used by the Federal Open Market Committee, where only a rotating subset of national representatives votes, along with the six permanent members of the Executive Board; and restricting voting rights to the Executive Board. The ECB has evidently opted for a form of rotation, in which euro zone members would be divided into three groups – the large countries (Germany, France, Spain, Italy, and Britain if it joins), which would have four votes; the middle sized countries, which would share eight votes, and the small countries, who would share three votes. Thus, the large countries would be represented by voting members most of the time, the middle sized countries some of the time, and the small countries only occasionally.

In opting for rotation, the ECB embraced the dominant recommendation of academics.³³ It was clearly wise to rule out a constituency system: this would have resulted in most meaningful discussion taking place within constituencies prior to the meeting of Governing Council and forced the representatives of the constituencies to read from prepared scripts,

³³Including yours truly (Eichengreen 2002).

discouraging a frank exchange of views. But the problem with the resulting reform is not just that it creates hard feelings by treating large and small countries differently but that it does not solve the large-numbers problem (since the number of votes in the governing council could still be as high as 21). Moreover, the rotating members might be encouraged by their differential status to see themselves as representatives of large, medium-sized or small countries.

Identification with a particular part of the eurozone might be strengthened, not weakened, which is the opposite of what is needed for the Council to formulate a policy suitable for the monetary union as a whole.³⁴

The FOMC model suggests supplementing the six voting members of the governing council with no more than four national representatives. But the eurozone will soon have twice as many members as the Federal Reserve System has reserve banks. The randomly-selected national representatives would then vote on the governing council at most a fifth of the time. Rather than expending precious political capital on such a reform, it would make more sense to eliminate national representation and to rely instead on the wisdom of the independent Executive Board (which is the approach of the Bank of England, the Swedish Riksbank, the Bank of Canada and a growing number of other central banks). The constraint, once again, is that the members of the Executive Board, who answer to no national government, might be regarded as inadequately accountable.³⁵ This points to the need for political reforms that would create a political counterweight to the EU's economic policy making institutions (including but not limited to the ECB). It is to this problem that I now turn.

³⁴As argued by Giavazzi (2003).

³⁵National central bank governors who sit on the board at present are accountable to their national governments, for better and for worse.

5. Political Integration

The constitutional convention has received proposals for every imaginable change in Europe's political architecture, from strengthening the presidency of the Commission, to strengthening the presidency of the Council, to strengthening the European Parliament, to returning many of the EU's significance prerogatives to the governments of the member states.³⁶ Much of this discussion has proceeded without clearly stated objectives. Political institutions are not an end in themselves; they are only handmaidens designed to deliver efficient, equitable, and politically legitimate outcomes.

The preceding analysis points to the type of outcomes that should result from a well-crafted political reform.

- The EU must have a strong executive branch or authority capable of executing economic policy decisions that can only be efficiently undertaken by a central authority in areas such as trade policy, competition policy, and monetary policy. Increasingly, the same need for a strong executive authority will also exist in non-economic issue areas like internal and external security.
- The EU must also maintain the capacity to take decisions at a more decentralized level in cases where spillovers are more limited or the heterogeneity of preferences is more pronounced. Because spillovers are limited, not absent, it must maintain its ability to coordinate those national policies.
- The EU must develop a political process capable of holding the executive accountable for

³⁶It has also received a large number of superfluous or tangential proposals that do not obviously belong in a foundational document.

its actions. Without a mechanism for accountability, expanded executive authority will not be political legitimate, and its creation will be strongly resisted.

- Finally, the EU must develop a system of checks and balances to ensure the maintenance of an efficient and equitable division of competences between levels and branches of government. This system should also allow the EU's political institutions to evolve over time in response to changing preferences and conditions, as the political institutions of national governments have done.

Strengthening the executive and enhancing cooperation. The need for a strong executive capacity flows not just from the economics of the single market but also from security imperatives. Terrorists can move freely throughout a Europe without internal border controls. No single national police force can adequately track them. National governments have an incentive to free ride, to under-invest for example in border patrols when suspicious characters entering the EU through their borders can move freely to other member states and wreak their havoc there.³⁷ Efforts to more closely coordinate the enforcement of border controls may not be enough to reassure anxious member states that their neighbors are not free riding, especially in light of the pronounced differences in administrative competence of such enforcement agencies in Northern and Southern, and soon Western and Eastern, Europe. It thus may be necessary to establish and fund an EU border police.

More generally, internal security may require a European equivalent to the FBI,

³⁷One can well imagine how incidents of this type could undermine the single market by leading victimized nations to backtrack on their commitment to dismantle their internal border controls. Recall how 9/11 led the U.S. to tighten up on vehicular traffic entering the country from Canada and Mexico.

answerable to an EU executive, which assumes responsibility from individual states for crimes of exceptional gravity and which involve the crossing of state lines. Dealing with rogue states that threaten Europe's safety from outside may similarly require formulating security policy at the EU level. Rogue states that might target Europe with biological or nuclear weapons threaten the entire continent, not just the member state in which the device is set off. Again, precisely because the consequences are spread across several countries, there is an incentive for individual governments to free ride – to wait for their neighbors to take costly military or foreign policy actions. In principle, this problem can be addressed by coordinating national policies. But as illustrated by recent conflicts over how to define a common European policy toward Iraq, effective coordination is easier assumed than accomplished. If external security threats are serious, then Europe needs to develop the capacity to formulate a common external security policy in a more systematic and timely manner.

The question is who should be vested with these responsibilities. If the response takes the form of closer coordination of national policies, then the logical solution is to expand the authority of the President of the Council, which is made up of heads of state and cabinet ministers. Replacing the current arrangement in which the presidency of the Council rotates to a new national government every six months with Council President elected or appointed for a longer period, say five years, as recommended by the UK, would enable that coordination to occur more efficiently and effectively.

If, on the other hand, the response must extend to the formulation of a single policy at the EU level and allow for quick executive action, then a better solution would be to expand the authority of the President of the Commission. The Commission is the EU's central bureaucracy

and proto-executive branch. Its president is therefore the logical individual to be vested with the authority to take policy decisions by executive fiat. Concretely this means giving the Commission more authority in the area of foreign policy, in contrast to the current situation, where responsibility for the Union's foreign policy is split between a Commissioner for External Relations and a High Representative for Common Foreign and Security Policy, one of whom is answerable to the Commission and the other to the Council.

It is important to understand that the argument here is not to expand the powers and prerogatives of the President of the Commission in all issue areas. In some areas, such as taxation, labor market policy and redistribution, the theory of fiscal federalism suggests that the Commission should have not more power but less.

Still, the preceding discussion suggests that the further one looks into the future, the stronger becomes the case for strengthening the executive powers of the President of the Commission rather than the President of the Council, since the further one looks down the road, the less confidence one has in the adequacy of relying on the closer coordination of national policies. Of course, there is a temptation to have one's cake and eat it too, to recommend strengthening both presidents. Since a case can be made for unifying policy toward some problems while more closely coordinating national policies toward others, this idea is not entirely without merit. In addition to giving the President of the Commission additional authority for internal and external security, for example, it might make sense to lengthen the term of the Presidency of the Council from six months to, say, a year. One might consider implementing the Italian "double hat proposal," in which the President of the Commission also served as President of the Council, although this might give the Commission too many responsibilities and weaken

the EU's checks and balances.³⁸

But significantly strengthening the presidents of both the Commission and the Council would create turf battles and obscure rather than clarify the assignment of responsibilities. Ultimately, Europe must choose. The arguments here suggest that it should choose a stronger Commission President.

Enhancing legitimacy and accountability. Stronger executive powers are regarded as legitimate only when the entity exercising them is accountable for its actions. Thus, a decision to assign more executive powers to the President of the Commission also implies the need to strengthen his or her political accountability.

The European Parliament can already dissolve the Commission by tabling a vote of no confidence (as it did in the case of the Santer Commission), but only on grounds of incompetence, not political disagreement. One way of strengthening political accountability would therefore be to broaden the grounds on which a no-confidence vote can be taken. Another way would be to move toward election of the President of the Commission. The parliamentary option would involve having the European Parliament elect the President. The presidential model would opt instead for election by Europe's voters.

Both presidential and parliamentary systems have their advantages. Presidential systems offer superior accountability, since the president is directly answerable to the voters. The separation of powers between the legislature (which proposes legislation) and the executive (with powers of execution) limits corruption and abuses of power. The downside is that these different

³⁸Requiring unanimous consent to decisions within the Council is another perceived reason for its weakness. National governments could of course address this concern by agreeing to expand the range of questions that could be decided by qualified majority voting.

branches of government have an incentive to maintain their power and position by granting their constituents narrowly targeted redistributive programs. Pork barrel spending is a problem in presidential systems, in other words.

In parliamentary systems, in contrast, a majority coalition of representatives is vested with strong and comprehensive powers but is constantly at risk of losing them from a vote of no confidence. Policy outcomes have to be positive for the majority coalition; this leads to broad redistributive programs and high levels of spending on general public goods that benefit many voters. Parliamentary systems are thus better at this public good provision. The downside is that parliamentary government provides an incentive for politicians to collude to prolong the life of the government; principal-agent problems are more pervasive than in presidential systems. And parliamentary government tends to result in excessive levels of taxation and spending, since the majority benefits from getting the minority to pay some additional taxes.

The parliamentary model, in which the European Parliament would select the Commission, is attractive insofar as the provision of broad-based public goods such as internal and external security is a key challenge for the EU going forward. But accountability would only improve to a limited extent. Since the EP has limited powers, the citizens of its member states pay little attention to its election. If the only change of consequence is to empower the EP to select the President of the Commission, voters would have only one additional reason to pay attention. It is not clear what the advantage would be, in terms of accountability, of having the voters elect the President of the Commission at one remove. Given the fragmentation of the EP, this model might also result in unstable coalitions which limit the effectiveness of the resulting administrations.

The presidential model would provide more legitimacy and accountability; the Commission would be directly accountable to Europe's voters, not indirectly accountable through the European Parliament. The President of the Commission could react quickly to security threats without the risk of losing power due to a vote of no confidence. A presidential system would be less good in providing high levels of general public goods, but this might not be entirely bad to the extent that there are concerns about whether a more powerful EU might grab too much responsibility for such matters from the governments of the member states. On balance, these considerations incline me to favor the presidential model.

Of course, there would be significant resistance to directly electing the President of the Commission. Different member states have different electoral systems and traditions. That no candidate speaks the languages of all member states creates doubts about whether he could effectively bring his campaign to the voters. This creates the danger that campaigns for the presidency of the Commission might degenerate into populist sloganeering.

Together with my CEPR colleagues, I have suggested that the EU might solve these problems by adopting an electoral college system. As in the United States, each state would have a certain number of votes in the college. Some member states might wish to select their electors by a direct vote of citizens. Others might prefer a parliamentary model in which the national parliament cast votes for the electors. Still others might wish to delegate this responsibility to the national government.

With an electoral college, arrangements for choosing electors could evolve over time. As candidates took their campaigns directly to the voters and a greater sense of EU solidarity began to develop, additional countries could opt for direct election of their delegates. Ultimately, the

system might evolve into one similar to that through which the U.S. President is elected, but at a pace chosen by the individual member states.

A stronger Council also requires measures to enhance the accountability of that institution. Many of the Council's deliberations take place in secret. Greater transparency and openness would be an obvious mechanism for strengthening that institution's political accountability.

Checks and balances. More power to the President of the Commission implies the need for stronger checks and balances. One step in this direction would be to include in the EU's constitution an article on the principle of subsidiarity, which specifies that, in the absence of clear agreement to the contrary, power should devolve to the member states. The Court of Justice would then have the power to rule unconstitutional actions taken by the Commission President that overstepped his authority.

In addition, the Parliament could be empowered to take a vote of no confidence in the Commission on political grounds, as suggested above. The EP could also be given the power to initiate legislation and the right to approve or disapprove executive actions affecting internal and external security. It could be given expanded powers to oversee the actions of the EU's independent regulatory agencies.

In controversial areas like foreign policy, the Commission could be required to obtain the consent of the Council and the Parliament before taking action, just as the U.S. president must obtain the approval of Congress before waging war. In Europe's case, this requirement might be buttressed by giving the Council the explicit power to "switch on" and "switch off" the common foreign policy. With time, the switch might be turned on more frequently, or the default setting

might become “on.” But there would be no need for this in the short run.

6. Conclusion

Europe is embarked on creating an unprecedented set of economic and political arrangements. Economically, it is creating a transnational economic space that is more deeply and systematically integrated than its regional counterparts anywhere else in the world. Politically, it is contemplating – albeit not without resistance – new ways of sharing or pooling of national sovereignty.

A large literature asks whether these processes are related – whether economic integration creates pressure for political integration. The theory of fiscal federalism suggests, for better or worse, that the answer is “yes in some respects, no in others.” Where market integration creates the need for a strong central regulatory authority, a stronger Commission President is the logical entity to carry it out. Where cross-border spillovers are more limited and the heterogeneity of preferences is greater, the closer coordination of national policies, to be arranged by a stronger and more effective Council, is the appropriate instrument. I have argued that deeper integration and the growing urgency of common internal and external security concerns will heighten the need for a Commission President with significant executive powers. But executive powers are politically palatable only when there exist mechanisms for holding accountable the individual or entity charged with their execution. This is why Europe needs to contemplate direct or indirect election of the Commission President, ideally through an electoral college system that accommodates the heterogeneity of preferences and views about how this should take place.

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