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Special Issue on Political and Economic Consequences of Economic and Monetary Union: Taking Stock of the First Eight Years

Guest Editor: Amy Verdun

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POLITICAL AND ECONOMIC CONSEQUENCES OF ECONOMIC AND MONETARY UNION: TAKING STOCK OF THE FIRST EIGHT YEARS

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With the creation of Economic and Monetary Union (EMU) in the European Union (EU), now eight years ago, we can all start to look back and reflect on the time that has passed and the challenges and opportunities that lie ahead. Created on 1 January 1999 with banknotes and coins introduced into the marketplace on 1 January 2002 EMU has by many been heralded as an unprecedented success of economic and monetary integration.

Many have focused on the sheer size of the project: twelve European Union member states introduced banknotes and coins in 2002 as legal tender replacing their previous national currencies, many of which had been around for centuries. As of 1 January 2007 Slovenia is the newest country to join. Another remarkable feat was the fact that a new European Central Bank (ECB) was created to formulate a single monetary policy for the eurozone. At the same time EMU leaves responsibility for budgetary and fiscal policies to national governments who still decide the level of expenditure and of taxes for its own subjects. Reflecting on these shared roles one can easily see that EMU did not introduce a fully-fledged federal regime in the area of economic and monetary integration. Rather it centralized only monetary policy leaving much of the responsibility over economic policy lie with member states.

Furthermore, EMU sits within a broader framework of European integration that itself is continuously in flux. The European Union experienced many transformations throughout the 1990s and the first years of 2000s. After numerous consecutive treaty changes (in Maastricht 1992, Amsterdam 1997 and Nice 2001),

it sought to have its legal basis integrated and specified in a single document ‘A Treaty Establishing a Constitution for Europe’. The document was adopted by Heads of State or Government in June 2004 but failed to obtain the necessary support in national referenda in two member states, in spring 2005, leaving the ratification process in limbo. Despite the constitutional struggles, the EU’s developments are continuous and keep progressing in various aspects related to economic and monetary integration, such as in the general area of services integration but also more specifically cooperation in the area of taxation and financial services.

The creation of EMU has had many thinking about some of its more specific implications. This special issue brings together authors who discuss some of those political and economic consequences that are now percolating down since EMU was created. We can broadly group the issues raised and discussed in this special issue under three headings: (1) the impact of EMU on selected cases and policies; (2) implications of EMU for governance; and (3) implications of EMU for fiscal policy. Under the first heading we find the paper by Marzinotto who examines the effect of EMU on Germany – the country that had been the leader in the pre-EMU era. She argues that Germany is performing worse than expected in EMU. A second paper in this category is the one by Bolukbasi that looks at how EMU affects Europe’s social model of society especially in light of the rejection of the Constitutional Treaty in the two referenda. The next heading ‘governance’ contains three papers. The first one, by Schure and Verdun, offers a more general governance framework inspired by the case of the Stability and Growth Pact. It provides an analysis of the behaviour of small and large member states in the Council, and what can be learnt from that analysis for understanding strategic behaviour of the EU member states more generally in the process of adopting legislative acts. The paper by Fritz examines the governance structure of the ECB and questions related to efficiency and appropriateness of monetary policy decisions once ECB reforms enter into force, that is, after EMU enlargement. The final governance paper, by McKeen-Edwards and Roberge, discusses the legitimacy issues related to developments in the area of financial services. The final part of this special issue focuses on the fiscal dimension. The first of the papers on this theme is by De Bonis and Della Posta, who offer a formal model of the relationship between fiscal and monetary authorities and the role of both in coordinating budgetary, fiscal and monetary policies. They provide an analysis that explains the rationale behind fiscal rules for both small and large member states. The next paper by Van Nispen offers an examination of variance among the various national budgetary deficits, including an assessment of the role of culture. Finally, O’Brien looks at the potential impact of direct taxation

jurisprudence of the European Court of Justice on member state budgetary discipline.

These contributions offer interesting insights into these very timely matters. First versions of each of these papers (and, in fact many others¹) were presented at a conference at the University of Victoria on 18-19 August 2005.² The papers selected for this special issue were subsequently revised and each of them sent off to two referees in a double-blind refereeing process. A number of them also were sent another time to a reviewer. This special issue was finalized in mid October 2006.

I hope that the special issue that lies before you will enlighten you and will trigger further debates on the consequences of EMU – debates which I believe will remain very salient for many years to come.

Victoria, B.C. October 2006

¹ Some of the other papers have meanwhile been published in Francisco Torres, Amy Verdun and Hubert Zimmermann (eds) (2006) *EMU Rules: The Political and Economic Consequences of European Monetary Integration*, Baden-Baden: Nomos publishing, ISBN 3-8329-1974-0.

² As organizer of that conference and guest editor of this special issue, the author expresses her thanks for a Jean Monnet Centre of Excellence grant from the European Commission to the University of Victoria, a SSHRC conference grant (646-2005-0107), and funds from the British Council, the German Consulate, and the University of Victoria, all of which contributed importantly to supporting the 18-19 August 2005 conference in Victoria B.C. Canada, and subsequently this publication. The author also extends her thanks to Melissa Padfield and in particular Ben Gonzalez for invaluable research and editorial assistance. She thanks the editors of *Current Politics and Economics of Europe*, Patrick Crowley and David Howarth, for their feedback, suggestions, and continuing support, as well as the sixteen anonymous referees who reviewed the papers in this publication. A final word of thanks goes to the participants of the August 2005 Victoria conference, who provided initial feedback and contributed to a first critical discussion of the earlier papers.

HAS EMU MADE GERMANY WORSE-OFF? MONETARY AGGREGATES, FISCAL AND WAGE POLICY IN THE NEW REGIME

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ABSTRACT

This paper analyzes the impact of Economic and Monetary Union (EMU) on the German economy and argues that the regime change that came with European monetary unification has been more dramatic in this country than in the rest of the eurozone, leaving the country relatively worse-off than its partners. While EMU's fiscal framework is often identified as one of Germany's worst enemies, I suggest that it is not so much this framework but rather the loss of monetary sovereignty which explains the country's below-average performance. EMU's one-size-fits-all monetary policy negatively affects the German economy in two ways. First, real monetary conditions are more restrictive in this country than in other member states because the country's inflation rate remains below the eurozone average in a situation in which the European Central Bank (ECB) sets interest rates based on aggregate price levels of the euro-area as a whole. Second, EMU has disrupted the previously well-functioning coordination game between German wage bargainers and monetary authorities, leading to more rather than less wage restraint. This situation has arisen because national unions believe they might be capable of influencing price levels in EMU given the size of the economy they represent. Excessive wage restraint with its

¹ I am grateful to Florin Bilbie, Stefan Collignon, Mark Hallerberg, Dermot Hodson, Manolo Palazuelos-Martinez, Patrizia Tiberi Vipraio, and to two anonymous referees for extremely useful comments. The usual disclaimer applies. A previous version of this paper was presented at the international conference 'Political and Economic Consequences of European Monetary Unification', University of Victoria (Canada) on 18-19 August 2005.

dampening effect on private consumption is thus an inheritance of EMU, even if not exclusively.

INTRODUCTION

This paper analyzes the impact of Economic and Monetary Union (EMU) on the German economy and argues that the regime change that came with European monetary unification has been more dramatic for Germany than for the rest of the eurozone, leaving the country relatively worse-off than its partners. While EMU's fiscal framework, i.e. the imposition of a rigid deficit ceiling, is often identified as one of Germany's worst enemies (Bibow 2005; Hein and Truger 2005), this paper suggests that it is not so much this framework but rather the loss of monetary sovereignty (and hegemony) that explains the country's below-average macroeconomic performance until 2005. EMU's one-size-fits-all monetary policy has deprived German economic authorities of the capacity to steer the economy through the direct control over real interest rates, which negatively affects the German economy in two ways. First, real monetary conditions are here more restrictive than in other EMU member states because Germany's rate of inflation remains below the eurozone average, whilst the mandate of the European Central Bank (ECB) is to provide one interest rate based on the aggregate statistics of the eurozone as a whole. To be fair, this topic is recurrent in the literature and now part of the conventional wisdom (Bibow 2005; Hein and Truger 2005; Enderlein 2006; OECD 2004). Second, EMU has disrupted the previously well-functioning coordination game between national wage bargainers and monetary authorities. Nevertheless, this has not led to a reduction of restraint as anticipated by Iversen and Soskice (1998), but to continuing moderation (see Table 1), and thus to a fall in disposable income that is now partly responsible for sluggish private consumption, with the latter making up for 0.75 per cent of German Gross Domestic Product (GDP) growth. At the same time, wage compression pushes inflation down and, more specifically, below the euro area average, enhancing the tightness of the EMU monetary stance for Germany. The second part of this argument explicitly challenges existing research on the interaction between a single monetary policy in EMU and multiple wage bargaining systems (see also Franzese and Hall 2000). My core proposition is that German unions' awareness of their capacity to influence average price conditions because of the relative size of the economy they represent is twisting their arms' into wage restraint, adding to other economic pressures (e.g. market integration) and structural conditions (e.g. declining unions' bargaining power and/or rising bargaining strength of

employers), which concern most European countries on largely equal terms. To put it differently, I suggest that the size of the German economy – a condition that is internalized, albeit imperfectly, by national wage bargainers – functions as a permanent institutional (downwards) pressure on wage behaviour. The fact that the Austrian economy has not undergone the same experience as Germany even if exposed to comparable pressures would bear this out. At the same time, not even in France, where the high number of multinational firms makes relocation a highly realistic investment decision, is wage restraint as evident as in Germany.² In brief, remarkably slow wage growth with its direct negative impact on domestic demand and the indirect influence on the country's real monetary stance is an inheritance of the new EMU regime, even if not exclusively so.

When trying to make sense of Germany's below-average recent macroeconomic performance, the existing literature has looked at the impact of competitive pressures in the Single European Market (SEM) and/or at the country's institutional sclerosis characterized by a grown-to-limit welfare state and various labour market rigidities. Whilst recognizing the value of economic and national institutional explanations of Germany's recent economic malaise, this paper adds an additional dimension to the debate by arguing that the overall EMU framework -and not the Stability and Growth Pact (SGP) alone- has put an additional pressure on wage demands, and thus on national economic activities .

The conclusions one can draw from the research presented here have far-reaching implications that concern both the specific case under investigation and the EMU architecture as a whole. As concerns the German economy, the central argument developed here would imply that the cure to the country's malaise should consist of a change to the institutional set-up against which the national economy operates rather than being purely economic (e.g. a mere increase in wages or a rise in productivity). At the same time, however, as there is no evidence to suggest that fiscal policy coordination in EMU has been Pareto-inefficient for Germany, the reform of the SGP approved in March 2005 – whatever its interpretation – may leave the German economy unaffected. Institutional reforms in Europe should rather focus on the ECB as well as on EMU's overarching framework. And indeed, Germany's disappointing macroeconomic performance should be a matter of concern when considering the

² The only other country besides Germany targeting wage restraint to stay competitive is the Netherlands. The fact that the Netherlands have experienced a boom whilst Germany was close to recession even if both were using wage moderation to support export growth derives from the fact that exports make up for a higher share of GDP growth in the Netherlands than they do in Germany, where it is instead private consumption, constrained by modest wage growth, that is the most important demand component of GDP growth.

fact that EMU was designed on a German blueprint in the aspiration that it would replicate the country's successful macroeconomic management. In the medium-term, other euro area members may fall victim of a similar bust cycle if Germany continues exerting a downward pressure on average inflation in EMU, thus making the ECB's monetary policy excessively restrictive for a majority of EMU member states. In addition, Germany's gain in competitiveness achieved through below-average unit labour cost growth will put pressure on wage policy in the rest of the euro area (see also Hein, Schulten and Truger 2004). Finally, this paper confirms that monetary unification is far from an unconditional blessing and that greater attention should be devoted to its distributional implications.

This paper is organized as follows. The first section provides a brief functional review of the main arguments employed to explain the German malaise and recognizes the superior explanatory power of accounts that associate the country's disappointing growth performance with EMU's overarching framework. The second section discusses the impact of the SGP on German budget policy, concluding that the Pact has not dramatically altered the conduct of fiscal policy. The third part develops the argument about losses associated with the devolution of monetary sovereignty to the supranational ECB. First, the introduction of the euro has deprived German governments of the opportunity to steer the economy through the interest rate. Second, and more originally, EMU has been Pareto-inefficient for Germany especially because it has disrupted the coordination game between monetary authorities and national wage bargainers. This has led to more rather than less wage restraint, causing a fall in disposable income, which is one even if probably not the only reason behind sluggish private consumption patterns. The latter is certainly the weakest link in recent growth trends as it will be indicated below. The fourth part summarizes the argument and briefly discusses its implications.

1. THE GERMAN DISEASE: FACTS AND THEORIES

EMU has so far disappointed expectations, but the performance of Germany is especially upsetting, not least because the project for monetary unification was based on a German blueprint. From 1999 to 2005, real GDP growth in Germany averaged 1.2 per cent, down from 1.9 per cent, in the period 1991-1998. The eurozone as a whole did not suffer from a deceleration in growth since 1999, as growth remained around 2 per cent over both periods from 1991 to 2005. Nor is the economic impact of reunification a satisfactory explanation to the country's below-average growth performance. If anything, with the enlargement of the

German marketplace, growth effects should have been enhanced. Such a perspective is even more convincing if one considers that the need to support the weaker East German political economy undoubtedly called for a rather expansive fiscal stance at the same time when most EMU members were heading down the road to fiscal retrenchment in the attempt to comply with the SGP provisions. From 1999 to 2005, Germany's public deficit has risen by 1.8 per cent of GDP against an average deterioration of 1.3 per cent in the rest of the euro area. In fact, the German government was found guilty of exceeding the three per cent deficit target envisaged in the Maastricht Treaty since 2002 with rules about violation subsequently spelt-out in the SGP (European Commission 2002). A relatively expansionary fiscal stance was insufficient to give a boost to the national economy. Germany has been standing out for its sluggish private consumption, constrained by a fall in disposal income following extraordinarily slow wage growth³, and thus for poor economic growth, considering that the contribution of consumption to GDP growth averaged 0.8 per cent over the 1999-2005 period against a more impressive average of 1.8 per cent from 1991 to 1995 (European Commission 2006b). In parallel, the moderate growth in remunerations contributed to bringing the country's inflation further below the eurozone average⁴, with the result that real interest rates have been systematically higher than those of EMU member states where inflation was instead on the upside (e.g. Ireland, Portugal, Spain).

Different explanations have been put forward to account for the German malaise. I distinguish between economic, structural and EMU-related explanations. The public debate is pervaded with references to the negative impact of market integration and stronger competition from other European economies. Similarly, the German economy had to face the new challenges that came from the so-called completion of the Single European Market by the end of 1992, its enlargement to Central and Eastern Europe in 2004 and the ongoing globalization process. However, rising competition from Eastern Europe and Asia does not seem to have compromised the country's export performance. In contrast, against

³ This is not to deny that other forces should have contributed to dampening private consumption such as deteriorating expectations and the uncertainty about the effects of labour and social security reforms.

⁴ Existing research confirms that the evolution of unit labour costs (ULC) bears a significant impact on inflation levels in the following year. A study conducted by Hein et al. (2004) and covering the period from 1961 to 2003 finds that the coefficient of determination stands at 58 per cent in the case of Germany but rises to a significant 78 per cent in the case of EMU at large. More to the point, data analysis by Marzinotto (2006) shows that Germany's decelerating inflation over the 1999-2005 period was caused more specifically by slower wage growth rather than by other factors such as a rise in labour productivity (which is included in the definition of ULC), declining mark-ups or lower indirect taxation.

a background of remarkably weak domestic demand, exports have performed brilliantly and well above the eurozone average (Bundesverband der Deutschen Industrie (BDI) 2004; *The Economist* August 2005). In this respect, basic economic explanations that focus on the effects of market integration are not fully convincing.

Still, some analysts insist on arguing that Germany's competitiveness would be at risk in the medium-term as structural features of the national political economy make the system hardly responsive to external challenges. The reference in the debate is to Germany's institutional sclerosis. Criticism is directed towards the country's rigid labour market and welfare institutions that discourage individual entrepreneurship and lead to excessive labour costs (Siebert 1997; BDI 2000, 2002; Heckman 2002). While these analyses have some merits, they remain incomplete. Welfare systems in the Netherlands and in Scandinavian countries are equally generous and relatively rigid too, yet this feature has not compromised their growth performance, as yet. An argument developed in the literature is that the Netherlands and Scandinavian countries have performed well in spite of the presence of fairly generous social protection systems thanks to high labour participation supported by high rates of part-time female employment in the service sector (Iversen and Wren 1998), whereas the German economy should have lost its competitive edge because it remains based on obsolete manufacturing activities. Whilst it is indisputable that Germany is in need of a more dynamic and innovative service sector, the evidence suggests that the only sector experiencing significant competitiveness gains in the period from 1999 to 2005 has been that of tradable goods, most notably industry, where they have been decreasing faster than in the service sector thanks to extraordinary wage restraint and not much to gains in productivity, as in fact the latter remained unchanged overall from the pre-EMU period (Marzinotto 2006).⁵ Furthermore, a study conducted by Hein and Truger shows that Germany's institutional rigidities have not become more acute now than they were in the 1970s, when the country was standing out as a role model of successful macroeconomic management (Hein and Truger 2005). Rather, something has changed in the environment in which the country operates that goes beyond the common challenge from internationalization and the rigidity of labour market and welfare institutions.

⁵ As will be explained below, wage earners in sectors that are typically exposed (i.e. manufacturing) are believed to have a stronger incentive for restraint as, first, staying competitive in an enlarged European market allows them to keep their jobs and, second, because the possible restrictive response by the inflation-averse ECB would not only deteriorate demand conditions at home, but it would also do so abroad, thereby reducing the appetite for imports from Germany (see also Marzinotto 2007).

Following this intuition, in recent times, a few researchers have been looking at the new EMU regime as a possible explanation to the country's below-average macroeconomic performance (*The Economist* June 2003). The recurrent argument is that Germany suffers from ill-coordinated macro-economic policies (Bibow 2005). Shifting the focus away from the supply- to the demand-side of the economy, Hein and Truger summarize their argument as follows:

'In sum, macroeconomic policy variables have indeed been less favourable in Germany than in the EMU since the mid 1990s. Macroeconomic mismanagement, therefore, can be considered to be the main cause of Germany's slump. This is partly due to the integration of a former key currency country into a monetary union and the associated loss of the interest rate advantage, and is insofar inevitable. But it is also caused by the restrictive macroeconomic policy mix implemented at the EMU level, which is particularly affecting a slowly growing low inflation country like Germany: the too restrictive ECB monetary policy strategy and the Stability and Growth Pact enforcing a restrictive stance on the member state' fiscal policies. And a major contribution to macroeconomic mismanagement has come from German wage developments' (Hein and Truger 2005: 17-18).

Privileging EMU-related accounts of the German disease, the following sections review the most important institutional changes that came with the introduction of the euro and test how these have affected Germany's fiscal and wage policy, the resulting macroeconomic policy-mix and, ultimately its growth performance.

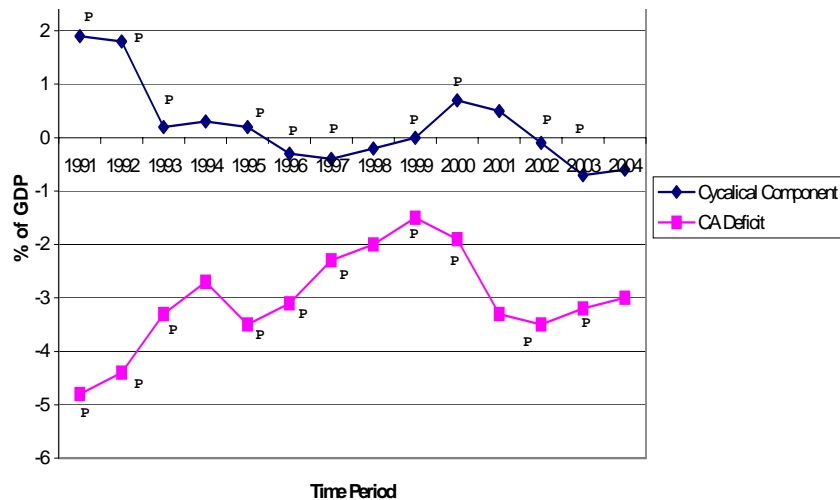
2. IS THE STABILITY AND GROWTH PACT A SELF-DEFEATING DEVICE?

Some of the observers of EMU's fiscal framework blame the Stability and Growth Pact (SGP) for forcing EU governments to run prudent fiscal action in bad times, thereby protracting downturns. The Pact's procyclical bias is aggravated by the fact that no positive incentive is available for countries to pursue disciplined budget policies in good times, with the result that the room for fiscal manoeuvre remains limited once the cycle turns unfavourable (Buti, Franco and Ongena 1998; Buti and Sapir 1998; von Hagen 2002; Buti, Eijffinger and Franco 2005). The new fiscal regime would thus deprive national discretionary fiscal policies of their stabilizing function (Fatas and Mihov 2002). In a similar fashion, a considerable number of analyses of the German malaise would

recognize the SGP as partly responsible for the country's protracted slow growth due to enforced budget consolidation in face of an economic slowdown (Hein and Truger 2005), especially in 2002 and 2003 when the downturn has been more severe than ever. A similar view has been expressed by the *Deutscher Gewerkschaftsbund* (DGB), (the German confederation of trade unions) - an umbrella organization in which all main labour unions are member and which represents more than seven million people. Since the inception of EMU and the coming into operation of the SGP regime, the DGB has been publicly criticizing the procyclical bias in the Pact, blaming the government for agreeing to cut public spending exactly at a time when this was mostly needed to counteract recessionary tendencies (DGB 2001a, 2001b). The DGB reiterated the criticism already expressed by some relevant economic research, that the SGP would force procyclicality in downturns without offering special provisions for booming national economies (DGB 2002b, 2005).

While this view has been echoed in the academic literature (Buti, Eijffinger and Franco 2005) and in some influential public circles (DGB 2001a, 2001b; The Guardian 2003), the empirical evidence in its support remains weak. In reality, German fiscal authorities have never been prompt when it came time to smooth out the cycle through fiscal policies. Germany's discretionary fiscal action has shown a tendency towards procyclicality since the 1970s (see also Gali and Perotti 2003; IMF 2004: 111), so that the coming into effect of the SGP does not seem to have exacerbated this predisposition, nor did the shock of reunification in the early 1990s. For the sake of the present exercise, a fiscal policy stance is said to be procyclical when the fluctuations in the cyclically adjusted budget balance move inversely with the output gap (for a definition, see OECD 2003). Figure 1 shows how this has occurred for most of the 1990s, namely in 1991-1993, 1995-1997, 1999-2000 and 2002-2003. In other words, the implementation of the SGP in 1997 has not coincided with a structural break in the conduct of German budget policy. Most interestingly, the relationship between the sign of discretionary fiscal policy and the growth environment is relatively symmetrical in that it is equally true that deficits rise during upturns and that they decrease in downturns, without macro-differences emerging if one compares the period before 1997 with thereafter. Hence, if it is true that, under the Stability and Growth Pact regime, fiscal policy has been procyclical, there is no evidence indicating that responsibility for this rests with the Pact. Nor it is the case that the Maastricht convergence process with its potentially restrictive bias has induced procyclicality. Had that been the case, we should not have seen procyclical fiscal

action in good times.⁶ Instead, Germany's procyclical behaviour has arguably to do with the institutional framework in which fiscal decisions are taken, and most notably with the country's federalist structure that maximizes collective action problems exactly when a coordinated action would be required, as suggested by some relevant literature (Braun, Bullinger and Waelti 2002), an issue that is not subject of investigation in this paper.



Source: European Commission (2005a).

Figure 1. Germany: Cyclical Component and Cyclically Adjusted Deficit 1991-2004 (based on potential GDP).

The new EMU regime not only encourages a balanced budget rule, imposed from above, but also a new architecture for all member states' fiscal-monetary policy mix. More precisely, monetary sovereignty has been fully devolved to the ECB, whilst fiscal policy is subject to the restrictions imposed by the SGP. Germany has enjoyed a long tradition of effective coordination between fiscal and monetary policy that was there to unveil a fundamental consensus on the orientation of the policy mix. The devolution of monetary sovereignty to the ECB certainly had the potential to jeopardize this condition by detaching fiscal from monetary policy. Nevertheless, *prima facie* evidence does not support this hypothesis. Germany's discretionary fiscal policy has been quite responsive to

⁶ Interestingly enough, even at aggregate level, an OECD study confirms that the constraints imposed both by the Maastricht Treaty (1992) and by the Stability and Growth Pact thereafter have not created a procyclical bias in EMU (OECD 2003).

real monetary conditions, expanding at times in which the ECB's monetary stance has been mostly restrictive. A recent econometric study conducted by the International Monetary Fund (IMF) to account for fiscal behaviour in the eurozone confirms that Germany is possibly the only country in which fiscal and monetary policies have gone hand in hand at least until 2003 (IMF 2004). In conclusion, it is neither the SGP alone nor the interaction between the new monetary policy in EMU and national fiscal policy-making the reason behind Germany's deteriorated macroeconomic performance after the introduction of the euro. The following section addresses the issue of the loss of monetary sovereignty and hegemony as well as its implications for monetary and wage policy coordination in Germany.

3. THE LOSS OF MONETARY SOVEREIGNTY AND HEGEMONY

3.1. The Real Effects of Below-Average Inflation

Monetary policy was certainly an important factor behind Germany's long-lasting macroeconomic success. From the mid 1970s until the start of EMU, the Bundesbank (the German central bank) pursued a non-accommodating policy relying on an effective regime of inflation targeting. The latter secured a few benefits but, most notably, it signified that the national central bank could take decisions on nominal interest rates with a view to the resulting real rate. In other words, monetary authorities were aware of the real effects of monetary policy, a condition that allowed them to steer the economy. In addition, the role of the deutschmark as the anchor currency within the European Monetary System (EMS) provided Germany with below-average real interest rates, which were an important support to domestic investment for at least two decades. EMU has clearly altered all of these mechanisms (see also Buti and Sapir 2002: 20). Most obviously, apart from the end of hegemony, the country has now lost monetary sovereignty. The power to decide on nominal interest rates, albeit against a numerical inflation target that is mimicking that of the Bundesbank, is a prerogative of the ECB. Most alarmingly, developments on labour markets have kept Germany's inflation rate well below the eurozone average with the result that the monetary policy of the ECB is now more restrictive for Germany than for the other EMU member states considering that the central bank is explicitly targeting aggregate price conditions in the euro area.

3.2. The Clumsy Coordination between the ECB and German Wage Bargainers

A further change that came with the new EMU regime, in particular with the ensuing loss of monetary sovereignty, was the detachment of monetary policy from wage-setting. The creation of a currency union and the devolution of monetary sovereignty to the ECB deprived German wage bargainers of their traditional monetary reference partner, potentially undermining the effective coordination game between the two actors. This is a topic widely treated in the literature and often evoked to explain Germany's historical record of slow inflation at negligible employment costs (Soskice 1990). According to the literature, the signalling game between the Bundesbank and wage bargainers has been happening through two (complementary) channels. In both of them, wage moderation is depicted as policy induced and, more precisely, conditioned by wage bargainers' expectations about the conduct of monetary policy by the Bundesbank. The bank's non-accommodating reaction function meant that excessive wage settlements bore substantial real costs that nullified any apparent short-term (nominal) benefit. This mechanism was in place only because wage bargainers were fully convinced of their central bank's inflation aversion – a belief strengthened by the fact that the bank was politically independent.

Wage bargainers would internalize the reaction function of the Bundesbank through two channels, as was alluded to above: an internal demand (ID) and an external demand (ED) transmission mechanism. As to the first, wage bargainers worked on the assumption that fast wage growth as wage-push inflation ($\uparrow\Delta W \rightarrow \uparrow\Delta P$) would induce a restrictive response from the Bundesbank ($\uparrow i$), which could dampen aggregate demand ($\downarrow AD$), and investment in particular, with inevitably negative consequences for national income ($\downarrow Y$) and unemployment levels ($\uparrow u$) [see equation 1]. Unions across all sectors felt this sort of pressure. At the same time, the actual delivery of wage moderation was made possible by the high coordination of collective bargaining, which in Germany took the form of so-called pattern-bargaining to indicate that one union plays the role of a leading wage-setter, i.e. the metalworking union *IG Metall*. As concerns the ED transmission mechanism, a few studies suggest that labour unions also considered the impact of monetary restriction on the exchange rate. An interest rate rise ($\uparrow i$) tended to lead to currency appreciation ($\uparrow \epsilon$) with the potential to jeopardize the national export performance ($\downarrow X$) and thereby influencing national income ($\downarrow Y$) and employment ($\uparrow u$) [see equation 2]. This was associated with significant distributional consequences insofar as it implied that unions concentrated in externally exposed sectors such as metalworkers (i.e. *IG Metall*) had a stronger

incentive for restraint than those in insulated sectors (Soskice 1990; Hall 1994; Iversen 1994; Franzese 1994, 1996; Hall and Franzese 1997; Iversen and Soskice 1998, 2000; Iversen et al. 2000; Traxler et al 2001). In brief, overall wage growth remained moderate in Germany for most of the post-war period thanks to the credible non-accommodating monetary policy conducted by the independent Bundesbank, but also thanks to the presence of an informally coordinated bargaining system. We can thus draw up the following equations:

$$\text{(Equation 1)} \quad \uparrow\Delta W \rightarrow \uparrow\Delta P \rightarrow \uparrow i \rightarrow \downarrow AD \rightarrow \downarrow Y \rightarrow \uparrow u$$

$$\text{(Equation 2)} \quad \uparrow\Delta W \rightarrow \uparrow\Delta P \rightarrow \uparrow i \rightarrow \uparrow \varepsilon \rightarrow \downarrow X \rightarrow \downarrow Y \rightarrow \uparrow u$$

In 1998, well before the inception of EMU, Iversen and Soskice (I-S) reviewed a few hypotheses about the impact of a single monetary policy in the presence of multiple collective bargaining systems. A first variable they had to account for was the behaviour of the new central bank. The ECB would have either targeted European inflation or de facto addressed price conditions in Germany. The expectations of wage bargainers were the second defining feature they needed to consider. German unions could either internalize the ECB's reaction function or not. While the propositions worked out by I-S hinged on merely tentative assumptions, the present work benefits from some practical insights into the actual behaviour of the ECB from 1999 to 2005 and into German wage bargainers' expectation formation. The latter process is traced back with the support of official documents and position papers released by the DGB, the confederation of German unions. Even if not statistically significant, this exercise offers some useful indications about the actual interactions, if any, between German wage-setting and the ECB.

Meant to mimic the Bundesbank, the new European Central Bank was made fully politically independent. These institutional preconditions were put in place so as to allow it to control inflation. Moreover, inspired by the mandate of the former, the ECB was given the mandate first and foremost to secure price stability. The ECB, in turn, interpreted this mandate as meaning that it would target an inflation rate of 2 per cent (which was the same reference value implicitly adopted by the German central bank since the mid 1970s). Against this background, some commentators anticipated that the ECB might have well used Germany as a benchmark and indeed address price conditions there (Iversen and Soskice 1998; Hancke and Soskice 2003). This has not occurred. Instead, the new central bank has been making an explicit effort to target the average inflation level in the eurozone (Allsopp and Artis 2003) and, most importantly, it has publicly

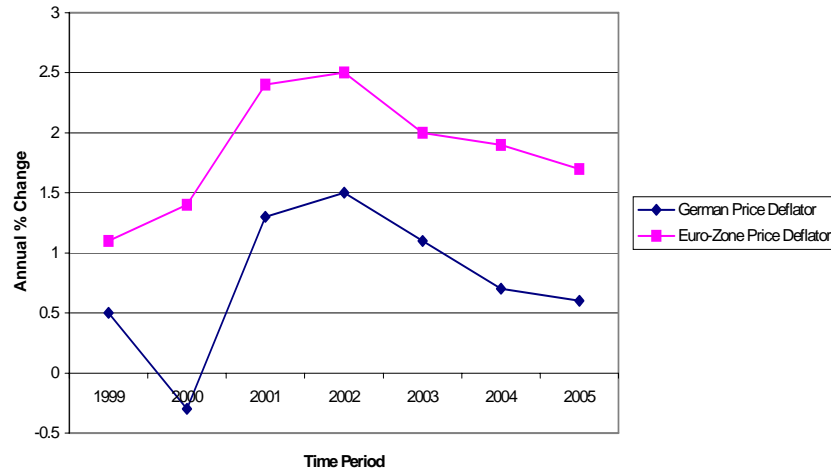
announced that it would do so. True, Germany is a price setter in EMU, not least because it represents about one third of the eurozone GDP. Proof of this is the perfect correspondence between the shape of the eurozone price deflator and Germany's over the period 1999-2005 (see Figure 2).⁷ Nevertheless, from 2001 to 2006, the German inflation rate has been deviating from the one recorded in France, the second largest European economy, by an average of 0.8 per cent (European Commission 2005b).⁸ Following the I-S hypotheses and given the behaviour of the ECB, the natural implication would be that German wage bargainers have a minor incentive for wage restraint as they would feel completely detached from the new supranational monetary authority, as explained by I-S:

‘...wage-bargainers will no longer be confronted with the likelihood monetary deflation as a direct response to increases in German wage and price inflation. This may alter the trade-off between employment and real wages for German unions in favour of higher real wages: there may be, *ceteris paribus*, a reduction of restraint on German wage-bargainers’ (Iversen and Soskice 1998: 112).

The empirical evidence speaks against this hypothesis. Germany's nominal as well as real wage growth have been remarkably slow over the period 1999-2005. Certainly, numerous factors can account for the downward trend in labour cost growth, ranging from mounting competitive pressures in an enlarging European market to declining union density. Nevertheless, as convincing as they might be, these explanations are not sufficient to account for Germany's below-average performance in EMU. Most EMU member states were in fact subject to the same sort of pressures. My core proposition is that German wage bargainers' conjectures about the response of the ECB must have played a role too, imposing moderation from above.

⁷ More sophisticated economic analyses further confirm that supply and demand shocks in the EU tend to be highly correlated with those occurring in Germany (Eichengreen cited in Soskice and Iversen 1998; Artis 2003).

⁸ The 2006 figure is an estimate.



Source: European Commission (2005b).

Figure 2. Price Deflator (GDP): Germany and the Eurozone 1999-2005.

3.3. Excessive Wage Restraint: Evidence and Explanations

As suggested earlier, wage settlements in Germany have been remarkably moderate since 1999 in comparison with the previous three decades and with developments in the other EMU member states. Since the introduction of the euro, average nominal compensations per employee have decreased by 54 per cent relative to the average in the period 1991-1998 against a fall of 14 per cent in the eurozone as a whole (EU-12 – the twelve countries that have adopted the euro). The evidence for moderate wage behaviour is even more striking when looking at real compensation growth. From 1999 to 2005, German wage bargainers have gone so far as to accept that their real bargained wages would remain unchanged relative to the average increase obtained in the previous seven years. This result compares poorly with the situation in the rest of the eurozone, where real wages have been rising on average by 67 per cent relative to 1991-1998 (Table 1).

There is no doubt that the German economic system has been particularly exposed to competitive pressures. On the one hand, the country's generous welfare system pushed labour costs above the average in the rest of the EU. However, rising competition is a phenomenon that concerns all European countries, in particular the more open economies such as Belgium or the Netherlands, where but overall wage growth per employee has been above

Germany's after the introduction of the euro. On the other hand, in Germany, geographic proximity made employers' threat of relocation to Central and Eastern European countries especially pressing. Nevertheless, labour is equally expensive in Austria and relocation a realistic scenario. Still, here, wage growth has not been as slow as in Germany.⁹ Furthermore, France, a country in which the high number of multinational firms makes relocation a highly realistic option (EIRO 2006), did not experience the same extent of wage restraint as Germany. Finally, labour costs can be under strain not only because of the relative flexibility of the national economic system in the face of market integration, but also because of structural reasons. Moderate wage settlements are often depicted as a consequence of unions' weakening bargaining power and/or of the rising bargaining strength of employers (Calmfors 2001). In fact, in the last few years, German unions have been unable to ensure that collectively agreed wage rises were actually implemented. Furthermore, fewer and fewer companies are now covered by collective agreements, especially in Eastern Europe (Bispinck 2003). This has led to the emergence of negative wage drifts which have slowed down wage growth. This outcome compares with largely positive wage drifts in the rest of EMU (Hein, Schulten and Truger 2004). Yet, the difference between actual earnings and collectively agreed remunerations is probably not sufficient to justify the remarkable difference in wage growth between Germany and the eurozone at large.

Table 1. Wage Developments 1999-2005 (annual % change).

	Nominal Wages*		Real Wages*	
	Germany	EU-12	Germany	EU-12
(a) 1961-70	8.6	10.3	5.7	5.6
(b) 1971-85	6.6	11.3	1.9	1.4
(a) – (b)	- 23%	+ 10%	- 67%	-75%
(c) 1986-90	3.2	5.2	1.8	1.3
(b) – (c)	- 52%	- 54%	- 5%	-7%
(d) 1991-98	2.6	2.8	0.6	0.3
(c) – (d)	- 25%	- 46%	-67%	-77%
(e) 1999-05	1.2	2.4	0	0.5
(d) – (e)	- 54%	- 14%	-100%	+67%

*Nominal and real wages are per head.

Source: European Commission (2006b); percentages calculated by the author.

⁹ Austria's wage growth was slower than Germany's only in 2001 (European Commission 2006: 52).

The argument developed here is that the new EMU regime itself has implicitly exercised some downward pressure on German wages and has done so more in this country than in the rest of the euro area. The comparative figures in Table 1 elucidate that the introduction of the euro has had some diversified impact on wage developments in Germany compared with the rest of the euro area. To be sure, in Germany, there has been a continuous deceleration in nominal wage growth since the 1960s (see also Schröder and Silva 2005), with an enhancement to the trend in the late 1980s that coincided with a period of relatively slow inflation both in Germany and in most European Monetary System (EMS) member states. The reunification shock and in particular the transfer of labour market institutions from West to East Germany had the effect of pushing aggregate wage levels upwards so that, from 1991 to 1998, nominal compensations – even if still on the downside – decreased by a more modest 25 per cent. With the normalization of labour market conditions in the reunited Germany, wage growth resumed the earlier (marked) downtrend. All the same, explaining Germany's recent wage restraint as a continuation of past trends would be unsatisfactory at least on two grounds. First, a closer look at real wage growth shows that the period 1999-2005 stands out as an extraordinary one in comparison with past decades as, for the first time, German wage bargainers accepted that bargaining rounds ended with zero wage increases. Second, and most significantly in the context of the present research, there are stark differences between developments in Germany and in the EU-12. Similarly to Germany, nominal wage growth has been on the downside in most EU Member states starting from the mid 1980s but, once in the monetary union, the decreases in compensation have been much less marked than in Germany, falling by just 14 per cent against 54 per cent in the latter. Most importantly, the trend in real wage growth was on the upside in the EU as a whole, rising by 67 per cent in 1999-2005 against the unusual phenomenon of flat real compensations in Germany. This evidence can be taken to suggest that the new EMU regime had a differentiated impact on wage developments in the two regions; *ceteris paribus*, i.e. imagining that the most common explanations to wage restraint such as economic pressures and structural conditions are largely the same for all euro area members.

3.4. German Wage Bargainers and the Formation of Expectations

The most original contribution this paper seeks to make to the existing debate consists of a qualitative analysis of expectation formation in the case of German wage bargainers with the support of official statements and position papers.

Labour unions' conjectures about the response of the ECB are a crucial variable in the determination of the German inflation/unemployment trade-off.

The documents produced by the trade union confederation DGB are pervaded with references to the possible impact of Germany's nominal wage growth on general price conditions. In fact, German labour unions acknowledge that their wage settlements might actually exert some impact on EU prices and wages¹⁰, having thus the potential to shape the reaction function of the ECB, albeit indirectly (DGB 2001b)¹¹. While wage bargainers in Germany are quite sensitive to their role as price-setters in the eurozone¹², they are nonetheless unable to predict if their marginal contribution to the average inflation level will take the latter above the two per cent reference value or not, as they have no means to predict wage behaviour in other EMU member states. This aspect is of great analytical and theoretical importance. It implies that, rather than internalizing the ECB's reaction function, unions are left with the option of internalizing just part of it. Thus, not only is the signalling game between the ECB and German wage bargainers entirely one-sided, but also rather clumsy with unions operating against an imperfect informational platform. More precisely, imperfect information takes two forms. One is unions' ignorance about trends in wages and prices in the rest of the eurozone, as suggested above. The second one concerns their fundamental uncertainty about the reaction function of the ECB, and more specifically about the relative importance that the new central bank attributes to price stability as opposed to growth. Previous literature has already pinpointed the existence of a positive relationship between monetary uncertainty and wage restraint, even if such an argument has never been explicitly applied to the interaction between the new ECB and German wage bargainers. Grüner, Hayo and Hefeker explain: '...risk averse labour unions internalise that increased wage demands could lead to a higher variance of inflation and unemployment when the central bank's reaction is less predictable. Therefore, ambiguous monetary policy reduces wage

¹⁰ This is in contrast with the theoretical proposition set forth by Hancké and Soskice (2003: 154) for whom 'national wage setters and national governments are only concerned to keep national inflation rates low to maintain or improve competitiveness: there is little incentive for individual economies to take into account the effect of their inflation rates on the Harmonised Index of Consumer Prices (HICP)'.

¹¹ This is also confirmed by econometric evidence. Posen and Gould (2006) find in fact that the credibility of the ECB's monetary policy is perfectly comparable to that of the Bundesbank. Hence, they do not identify any change in German wage setters' behaviour: "German wage bargainers continue to keep their eye on the ECB response to their negotiations much as they did on the Bundesbank's response" (p.16).

¹² Existing research confirms that inflation in Germany has a dominant forward-looking component whilst an inertial behaviour (backward looking) prevails in other euro area countries (Benigno 2006).

inflation’ (Grüner, Hayo and Hefeker 2005: 7). Against this new incentive structure, the ID transmission channel can be re-written as follows:

$$\text{(Equation 1*)} \quad \Delta W \rightarrow ? \Delta P \rightarrow ? i \rightarrow ? \Delta D \rightarrow ? Y \rightarrow ? u$$

And, from 2001, once it had become clear that the ECB was ready to constrain growth for the sake of controlling inflation, domestic wage behaviour became influenced by the expectation that the ECB’s monetary stance was overly restrictive to start with, as manifest in the following account:

‘An even more dynamic expansion of the economy could be achieved would the European Central Bank (ECB) consider realistically growth an objective in the same vein as price stability. By the way, these two objectives are not alternative. With nominal wages growing by 4 per cent on average, the distribution of output per head is not jeopardized. Real wages would thus grow together with productivity and wages per head increase by a rate that is compatible with price stability. This means that an expansionary monetary policy is not to entail an inflationary potential.’ [author’s own translation] (DBI 2001b: 13).

In turn, restraint was accepted not necessarily to avoid a restriction as in the past, but to try inducing an expansion (DGB 2001a, 2003, 2004), i.e. wage behaviour is not preventive anymore but it aims at triggering a reaction. An additional factor, as mentioned, is the size of the German economy relative to the rest of the eurozone. This relative size differential allows wage bargainers to internalize, albeit rather imperfectly, the ECB’s response. This unique German situation explains why a similar process is not in place in a small country like Austria where competitive pressures are also unfolding and where wage collective bargaining is as at least as coordinated as Germany’s.

The hypothesis set out above calls for a refreshed recollection of the operation of the German political economy. It is reasonable to expect that, in EMU, the ED channel is losing its importance relatively to the ID channel. This effect is enhanced in countries characterized by great trade openness and by intra-EU exports growing faster than extra-EU exports. Germany falls into this category. Intra-EU trade amounts to 90 per cent of the total export volume, amounting in 2005 to 786 millions euro (Bundesbank Statistics in: www.bundesbank.de). Moreover, exports directed to other EU countries have been growing by an average of 4.5 per cent over the period 1999-2004 – a nice result, compared to the disappointing performance of other member states (e.g. Belgium, Austria, Netherlands), where intra-EU exports have surprised with a decline since the

introduction of the euro. With internal trade dominating the country's international economic relations, German employees should be more concerned with the ID- than with the ED-effect of a monetary restriction by the ECB, considering that the latter would affect only the external value of the euro, and thus concern just extra-EU trade.

This new responsiveness has significant implications for the structure and operation of collective wage bargaining. In the face of the non-accommodating policy implemented by the ECB, all unions across the economy should perceive wage settlements as self-defeating independent of the relative openness of the sector in which they are concentrated. This should minimize cross-sectoral differences between collectively agreed wages. At the institutional level, this could lead to a weakening of *IG Metall's* wage-leading position. Preliminary indications seem to bear this out. Between 1994 and 1998, the standard deviation of agreed wage increases in metalworking from the average in the national economy amounted to 1; but increased, albeit slightly, to 1.1 over the period 1999-2005 (author's own calculations based on figures from WSI Tarifarchiv, www.dge.de).

Cross-sectoral differences in agreed wages, if any, should also end up being distributed in a different fashion. If the most worrying prospect has become a monetary restriction by the ECB with its dampening effect on domestic investment, then it is reasonable to expect that unions concentrated in capital-intensive and labour-poor sectors might have a stronger incentive for restraint than the others. To corroborate this point, even if not statistically significant but just indicative, is the fact that the German electronics sector saw its labour costs sinking by 27.2 per cent from 1995 to 2003 (IG-Metall 2003)¹³. All in all, it is realistic to think that, in the medium-term, Germany's wage-leadership should lose its institutional dimension and become contingent upon circumstances such as the euro/US dollar exchange rate, relative productivity gains, government fiscal policies and unions' immediate mobilization potential.

4. CONCLUSION

This paper has analyzed the impact of EMU on the German economy and concludes that the regime change causing European monetary unification has been more Pareto-inefficient for Germany than for the other monetary union partners.

¹³ Of course, this should be also the consequence of the fact that the sector might have suffered from the competition from China.

The coming into operation of EMU is thus one of the reasons behind the country's below-average performance, even if certainly not the only one. The aspect of the new macroeconomic framework that has exerted the most visible impact on the largest European economy is not the much-debated Stability and Growth Pact but rather the loss of monetary sovereignty (and hegemony). More specifically, once monetary sovereignty was lost, Germany has been suffering from comparatively high interest rates, considering that inflation has remained below average throughout the period 1999-2005. Second, I argue that EMU has disrupted the coordination game between monetary authorities and German wage bargainers. Yet, this has led to more rather than less restraint with unions moderating wage demands in a sort of pre-emptive action. Wage bargainers are in fact persuaded that national price changes could end up affecting average inflation in the eurozone, just because Germany represents one third of euro area GDP. Still, they are unsure of their marginal contribution to the overall resulting inflation rate. Under conditions of uncertainty, they would rather opt for moderation. This is not to deny that numerous factors are behind Germany's excessively moderate unit labour cost growth. Where this paper has not been able to deal with is spelling out the relationship between economic and structural accounts of wage moderation; an exercise that would have required an econometric analysis. Nevertheless, the specific purpose of the present research was to account for a new dimension and, more specifically, to address the gap between the I-S hypotheses and the empirical evidence on wage growth. The insights provided here are meant to complement, rather than substitute, existing accounts of the economic and institutional determinants of wage moderation. The ensuing policy implications are far-reaching. First, the paper confirms that monetary unification has significant distributional consequences that have not been taken into account sufficiently in its formative years. Second, the EMU framework might be in need of reform, yet it is the overarching architecture that should be restructured and not the specific content and operation of the SGP.

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***PLUS ÇA CHANGE ... ?* THE EUROPEAN
SOCIAL MODEL BETWEEN 'ECONOMIC
GOVERNANCE' AND 'SOCIAL EUROPE' FROM
THE MAASTRICHT TREATY TO THE
EUROPEAN CONSTITUTION**

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ABSTRACT

Underlying both scholarly and public debates leading up to the French rejection of the European Constitution was the common view that the European Union's economic and social governance had become increasingly characterized by a stark asymmetry of economic and social integration especially in the post-Maastricht period and that this would undermine the European Social Model. This paper argues that while such an asymmetric approach to economic and social governance is retained in the Constitution, apprehensions over the future of the European Social Model – scholarly and otherwise – are largely unsupported due to two empirical observations. First, although the highly asymmetric Maastricht Treaty that set up Economic and Monetary Union (EMU) was expected to undermine the European Social Model, the European welfare state panorama remained largely intact. Second, the Constitution introduced new openings in the area of social protection and

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thus provided a new platform for debating the future of a Social Europe alongside the tightly constitutionalized EMU-cum-economic governance.

1. INTRODUCTION

On 29 October 2004 European leaders signed a historic document – the Treaty Establishing a Constitution for Europe.² Thus the European Union (EU) would be governed by a single text that consolidated and simplified the existing treaties. In order for the Constitution to enter into force, all twenty-five EU member states had to ratify it. After several member states had successfully ratified it, however, the process came to a halt by two popular referenda on the text. The French ‘non’ on 29 May 2005 came in at 54.7 per cent, and on 1 June 2005, 61.5 per cent of the Dutch voted ‘nee’ in their referendum. While there remain several options for the constitutional future of the EU, currently the ratification process is *de facto* on hold.

At the heart of the ‘non’ unambiguously lay heightened social concerns (Reuters News 4 May 2005; Financial Times 6 April 2005; Baldwin 2005; Kenner 2005; Ross 2005; Taggart 2005; Whitman 2005; Degryse and Pochet 2006; Hainsworth 2006; Hopkin and Wincott 2006; Ivaldi 2006). According to the Eurobarometer poll (Eurostat 2005a)³ conducted immediately after the referendum, the French ‘non’ voters feared that the Constitution, in its present form, would compromise their national model of society: as reasons for their vote they reported that the Constitution would have ‘negative effects on the employment situation in France’ (31 per cent) against a background of ‘too much unemployment in France’ (26 per cent). Furthermore, with respect to EU’s economic governance, the draft was perceived to be ‘too [neo-]liberal’ (19 per cent). At the same time, the Constitution’s provisions on EU social policy were considered to be its Achilles heel: with respect to the state of the EU’s social dimension, voters reported that the Constitution did ‘not [have] enough Social Europe’ (16 per cent). Surprisingly, despite the clear ‘non’ in the referendum

² Henceforth, ‘Constitution’. The Constitution is both a treaty subject to the rules of international law and a constitution in that it contains elements of a constitutional nature. Strictly speaking, the resulting document looks more like a treaty as many observers have noted that it is much too detailed to be considered a proper constitution. At the same time, however, it a constitution as it contains the fundamental rules of a state (or a group of states) regarding the institutional structure, the arrangement for division of powers, the implementation of policies, and the values and fundamental rights of the citizens.

³ The results reported in the Eurobarometer are consistent with exit-polls conducted by other institutions.

French citizens remain overwhelmingly in favour of the EU (88 per cent) and an overwhelming majority finds the Constitution to be indispensable for pursuing European construction (75 per cent). This implies that it was *not* the *concept* of the Constitution itself that was rejected; rather, the French desired a *different* Constitution – almost every two out of three Frenchmen reported that the ‘non’ victory will increase the chances of a re-negotiation in order to achieve ‘a more social text’ (62 per cent).⁴

This outcome was not at all surprising. In the popular debate leading up to vote, it was clear that opposition to the Constitution was building on apprehensions that it failed to tackle the neo-liberal drive characterizing the period following the Treaty on European Union⁵ that would undermine the European Social Model.⁶ In this sense, the ‘non’ was a reaction more to what the EU had *already* become rather than what it would become *after* the Constitution: it was the perceived triumph of ‘Market Europe’ over ‘Social Europe’ that featured in the referendum campaigns. While the French public was concerned that ‘Market Europe’ was becoming the means through which the French model was being dismantled, the ‘non’ camp continuously emphasized that the Constitution did not go far enough in securing a ‘Social Europe’. Accordingly, many commentators predicted that the Constitution would eventually fall victim to policymakers’ widely perceived disregard of the social dimension (Kenner 2005; Agence Europe 1 June 2005).

Resonating these apprehensions, the conventional wisdom in the academic literature has consistently made dire predictions on the implications of the path European integration has come to take on the European Social Model. Underlying

⁴ Although the motivations behind the Dutch ‘nee’ do differ from those of the French ‘non’, a considerable majority of the ‘nee’ voters, too, believed that the rejection would facilitate a renegotiation of the Constitution in order to place greater emphasis on ‘Social Europe’. See the Eurobarometer survey on the post-referendum survey in the Netherlands (Eurostat 2005b).

⁵ Henceforth: Maastricht Treaty.

⁶ As a term espoused by Jacques Delors in the mid-1980s, the ‘European Social Model’ has come to designate an alternative to the American model of free-market capitalism. It describes the post-war European experience of promoting market liberalization aimed at economic growth on the one hand, and social and redistributive policies for achieving social progress and cohesion on the other, as essential and parallel elements of a prosperous European space (Ross 1995; Jepsen and Serrano Pascual 2005). Although there are alternative conceptions of the European Social Model, the most widely accepted definition (which is adopted here) refers a group of welfare regimes, varied as they are within the European Social Model and characterized by extensive systems of social protection and labour market institutions. Such a conception presupposed the national character of Europe’s welfare states that comprise the Model. In this context, underlying the efforts at creating what constitutes a ‘social dimension’ of the Community (which came to be increasingly referred to as ‘Social Europe’ especially in the 2000s) is the view that social provision may be protected and sustained by complementary action at the EU level. See below for alternative conceptions of Social Europe.

these predictions is the view that, especially in the post-Maastricht period, EU economic and social governance is characterized by a stark asymmetry whereby economic integration has always been the primary vocation while social integration remained only of secondary concern. As such, this hierarchical nature of economic and social governance in the EU is generally viewed to be the outcome of what Scharpf (2002) observes as the ‘constitutional asymmetry’ of economic and social governance. Shaw (2005: 1) summarizes this view by means of a simile: in European integration, social policy has been given a ‘Cinderella status’; ‘like Cinderella, social policy always gets left behind’. With respect to the consequences of such asymmetry, the concerns raised in the academic debate are not only limited to the expected detrimental impact of ever-deepening economic and monetary integration on welfare states; the literature also stresses the absence of pan-European social policy levers in helping the ‘semi-sovereign’ welfare states resist the very pressures stemming from integration. Under these circumstances, Scharpf (2002: 649) argues, there is a growing need to draw a ‘constitutional parallelism of economic (‘market-making’) and social-protection (‘market-correcting’) interests and policy purposes’. Accordingly, numerous studies have discussed whether, and to what extent, the European Social Model could be emancipated from the shackles of economic and monetary integration in the wake of the Constitution through not only changes in economic governance but also improvements in the social field (Hemerijck and Bergman 2004; Wendler 2004).

Are these popular and scholarly apprehensions over the future of the European Social Model justified in the wake of the Constitution? Did the Constitution, in fact, downplay the social dimension in favour of the dominant economic dimension of European integration? Even if it did, does it matter? In order to address these questions, in section 2, this paper sets the stage by providing an overview of the principles and nature of economic governance defined by Economic and Monetary Union (EMU) on the one hand and the attempts in the Maastricht Treaty at building a social dimension on the other. Although the asymmetric approach to economic and social governance dates back to the early days of the Community, it is through the Maastricht Treaty that a full-fledged EMU was created in the absence of a social dimension alongside it, which reflects most clearly the asymmetric approach to EU governance. In order to explore the dynamics underlying such asymmetry, the paper next reviews the process of intergovernmental negotiations on EMU and Political Union (PU) that culminated in the Maastricht Treaty. Third, it surveys the scholarly expectations regarding the impact of such asymmetrical governance on what constitutes a central pillar of the European Social Model – the welfare state – in the post-

Maastricht era. Such approaches led many scholars to expect that the European Social Model would effectively be undermined due, in large part, to the overly-restrictive policies EMU engendered. An analysis of social spending levels and processes of welfare reform in the post-Maastricht period, however, shows that the European Social Model seems to have stood up to pressures stemming from economic and monetary integration even when EMU was not flanked by a strong social dimension at the EU level. In section 3, the paper explores the question of whether, and to what extent, the Constitution addresses the existing asymmetry between EU's economic and social governance in the wake of constructing an ever-closer Union. Second, it reviews the process of deliberation of the treaty provisions on economic and social governance in the Convention by emphasizing the further consolidation of EMU, and the limited, yet promising, openings in EU social policy. Next, it demonstrates that while the resulting outcome in the Constitution, unsurprisingly, did not break new ground in terms of re-conceptualizing economic and social governance, it argues that the provisions in the Constitution may help put Social Europe on a firmer footing. Finally, it shows that Social Europe is being recast following the route of 'decentralized concertation' – perhaps the only politically feasible alternative given the obstacles facing alternative approaches. While 'second best' for many, this approach is premised on the widely debated Open Method of Coordination (OMC), with all its pitfalls and promises. Section 4 concludes by providing a brief discussion on the future of the European Social Model.

The paper argues that while the asymmetric approach to economic and social governance characterizing the Maastricht Treaty is retained squarely in the Constitution, apprehensions over the future of the European Social Model – scholarly and otherwise – are largely unsupported. It does so on the basis of two empirical observations: first, although the highly asymmetric Maastricht Treaty that set up Economic and Monetary Union was expected to have grave social consequences for the European Social Model (especially in the absence of compensatory mechanisms at the EU level), the European welfare state panorama remained largely intact in the post-Maastricht period. Second, although the Constitution retained the pre-existing asymmetric approach, developments in the European economic and social spheres and the provisions inserted into the Constitution pointed to openings in the area of social protection. These promise to enhance EU governance by providing a new platform for debating the future of a Social Europe alongside the tightly constitutionalized EMU-*cum*-economic governance. In the light of these observations, therefore, the European Social Model would be least likely to be destroyed with the Constitution not only in spite of the continued asymmetry of economic and social governance at the European

level but also against practically unanimous academic, political and popular predictions.

2. ECONOMIC AND SOCIAL GOVERNANCE IN THE MAASTRICHT TREATY

The Maastricht Treaty which defined the central institutional pillars of macroeconomic governance was the culmination of two parallel Intergovernmental Conferences (IGCs) – one on Economic and Monetary Union and a second on Political Union. Whereas economic and monetary matters were the subject of the IGC on EMU, matters related to social policy remained within the purview of the IGC on PU. The IGC on EMU called for the creation of perhaps the most far-reaching and the boldest project in Europe's half a century of integration but the IGC on PU produced only modest results in social policy. These negotiations produced an asymmetric outcome with respect to the institutionalization of economic governance on the one hand and the social dimension on the other.

2.1. The Nature and Principles of Economic Governance in the Maastricht Treaty

Informed by mainstream monetary theory that emphasized the reputation of institutions and the credibility of anti-inflationary commitments (summarized as 'Monetarism Mark II' *à la* Tobin⁷), the Maastricht Treaty epitomizes the historic conversion to macroeconomic discipline. The Treaty laid down the institutional framework of economic governance across the EU and still acts as *the* policy template for macroeconomic policies. EMU was based on the twin principles of macroeconomic discipline: 'price stability' and 'sound public finances'. First, the Treaty defined price stability as 'the primary objective' of the European System of Central Banks (ESCB) and foresaw the establishment of a new European Central Bank (ECB) that would design and implement the single monetary policy to that effect. The founding fathers of EMU thought that only by enshrining price

⁷ Originated by James Tobin (1981), the term 'Monetarism Mark II' describes the version of monetarism that emerged in the 1970s which is compatible with 'rational expectations'. It is also subsumed within 'new classical macroeconomics'. 'Monetarism Mark I' that incorporates 'adaptive expectations' is the original version that was advanced in the 1960s by Milton Friedman.

stability as an explicit priority could a sound and stable single currency be secured and that the ESCB should be independent of any instructions (Article 107). The independence of the ECB was further reinforced by what was omitted from the EMU framework: the ECB was not institutionally embedded in a *gouvernement économique* (Martin and Ross 2004a: 9).⁸

Second, the Treaty introduced several mechanisms to ensure ‘sound public finances’, as prudent budgetary policies were seen as central to achieving the overarching objective of price stability. Article 3a stipulates that the close coordination of economic policies is an activity of the member states and the Community. In particular, the Treaty emphasizes that macroeconomic policies in EMU entail compliance with the guiding principle of ‘sound public finances’. In pursuing the general objectives of the Community as set out in Articles 2, 3 and 102a, the Treaty views the coordination of budgetary and other economic policies of member states as a significant instrument and, therefore, the guiding principle of sound public finances has a general application. The Maastricht Treaty was thus designed to provide the larger context of fiscal prudence whereby national budgetary policies were implemented.

In order to achieve EMU, the Treaty introduced a set of restrictive eligibility requirements governing the transition period for joining EMU, known as the Maastricht convergence criteria.⁹ These criteria in effect acted as the parameters of macroeconomic policies of the EMU-candidates in the run-up to the single currency. There was an additional mechanism devised for monitoring the state of convergence with respect to the fiscal criteria – the Excessive Deficit Procedure (EDP).¹⁰ Moreover, member states were to remain committed to the fiscal rules not only during the transition stage but also once EMU began through the Stability and Growth Pact (SGP).

⁸ This French initiative aimed at an appropriate policy mix at the supranational level through explicit coordination of monetary, fiscal, exchange rate and structural policies. As an institutional arrangement, it would counterbalance the unidirectional drive towards ‘sound money’ through activist macroeconomic policy aimed at increasing economic growth and employment. At the same time, by embedding the ECB politically, it would help strengthen the Union’s democratic legitimacy and public accountability (Dyson 2000). See also Verdun (1996, 1998 and 2003), Dyson and Featherstone (1999) and Howarth (2005).

⁹ The criteria required that inflation and interest rates of candidates had to remain close to an average of those of the three best performing members, currencies had to have participated in the exchange rate mechanism for at least two years and annual budget deficits and public debt had to remain lower than three per cent and sixty per cent of Gross Domestic Product (GDP) respectively.

¹⁰ The EDP was designed to operationalize the Treaty principle that excessive deficits should be avoided. The procedure identifies whether there is an excessive deficit and defines the mechanism through which pressures are imposed.

2.2. Towards a ‘Social’ Europe? ‘A Saga of High Expectations and Modest Results’

The debate on European social policy revolves around two options: first, whether there should be more emphasis on ‘the social’ in European policies through the development of direct supranational measures, and second, whether ‘the EU’ should be more prominent in the social policies of member states by promoting harmonization, stipulating benchmarks, and guaranteeing minimum welfare standards across the EU (Chassard 2001). Imagining a Social Europe that would replicate the redistributive structures of the national welfare state at the supranational level, the former option is consistent with the ‘euro-corporatist’ vision whereby the EU would have direct supranational powers in setting uniform and binding standards in social policy. The EU’s role within the alternative option of ‘decentralized concertation’ as envisioned in euro-corporatism, albeit viewed as central, would be relegated to supporting and coordinating national welfare state activities through limited legislation yet supplementing them where necessary (Trubek and Trubek 2005).

The first option remained the road not taken for a number of reasons including the diversity within the European Social Model, the opposition to expansion of the Community mandate especially by Britain, the unfavourable balance of power among socio-political actors, and the lack of independent institutional, fiscal and administrative capacity of the EU (Pierson 1999). Foundations for a European welfare state were never put into place as the Community was ‘constitutionally barred’ from most welfare-state areas (Ross 1995: 238). The original treaties had also foreseen a minimal role for social policy issues because the founding fathers of the Community had placed their faith firmly in the automatic improvement of social conditions, relying on the assumed knock-on effect economic integration would produce (Ross 1995; Pakaslahti 1998; Hay 2000; Mousis 2005). Initiatives in this field reflected the national concerns of, and disagreements among, member states rather than any genuine commitment to a ‘European’ social dimension (van Kersbergen 2000). This meant that social competences remained almost exclusively with the nation state (Leibfried and Pierson 1995; Falkner 1998).

While competences in the area of social policy were incrementally creeping into the *acquis* through treaty revisions and rulings by the European Court of Justice, they remained very limited. At the Maastricht negotiation table, allied with President Jacques Delors, some governments attempted at making the principles of the Social Charter binding by inserting them into the Treaty. Britain fiercely opposed this initiative and the Chapter on Social Policy was signed as a

separate protocol.¹¹ The principle of subsidiarity adopted provided the legal basis for confining the control of social policies to the national level, leaving no room for a pan-European social policy. Despite some initiatives aimed at ‘Social Europe’ by President Delors in the following period, these were postponed, to be tackled after EMU had been institutionalized (Amin 1996: 369). Leibfried and Pierson aptly summarized the developments in the social policy area as ‘a saga of high aspirations and modest results’ (Leibfried and Pierson 1995: 46).

In the post-Maastricht era, social policy issues remained largely outside the negotiations even during the IGC leading to the Amsterdam Treaty (1997), with minor exceptions. After the elections in Britain, the Blair government ‘opted-in’ to the Social Agreement. Aside from this, the Treaty brought about no significant changes. The following Nice Treaty (2001), too, refrained from bringing innovation in the *acquis* except for signalling that the Council may decide unanimously in taking action in the area of social protection. All of these developments meant that with member states remaining reluctant to transfer control to the Union, the second option of limiting the EU’s activities to coordinating national welfare state activities increasingly gained popularity. Accordingly, the Lisbon agenda (2000) institutionalized the OMC for working towards shared European objectives through national plans which are assessed in relation to common indicators, guidelines and targets.¹²

¹¹ According to the resulting Agreement on Social Policy, Community competence has expanded to address questions of working conditions, information and consultation of workers, equality between men and women in the labour market, and integration of persons excluded from the labour market. Moreover, qualified majority voting was extended to other areas that were originally subject to a unanimity rule. However, unanimity remained the rule for matters on social security and social protection, the protection of workers whose contracts had been terminated, representation and collective defence of interests of workers, etc. (Falkner 1998).

¹² In the area of social protection and inclusion, the OMC premises on five main elements: i. agreeing on common objectives, ii. establishing common indicators as a means of comparing best practices and measuring progress, iii. translating the EU objectives into national/regional policies on the basis of national reports on strategies for social protection and social inclusion; iv. publishing reports analyzing and assessing these national reports; and finally, v. establishing a Community Action Program to promote policy cooperation and the transnational exchange of learning and good practices (Council of the European Union 2000). On the OMC, see also de la Porte and Pochet 2002 and Pochet 2005).

2.3. The IGC Process that Led to the Maastricht Treaty: Spillovers that Never Came

From the inception of the Community, economic integration was assumed to bring about eventually functional spillovers into the social field.¹³ The asymmetric approach adopted at the Maastricht negotiation table, however, represented a single-sided deepening in the economic field and a lack of development in the social field. This was the political outcome of the two mutually exclusive IGCs whereby the Social Dimension was assumed to act as subservient to Social Europe.

During the IGC negotiations on PU, Community social policies were the most controversial issues (Reuters News 4 December 1991). Although there were several attempts at balancing economic and social governance, social concerns did not find their way into the Treaty (Salais 2001: 424).¹⁴ The social dimension Delors planned to build side-by-side with EMU became part and parcel of the 'market-building process' (Leibfried and Pierson 1995: 51; Teague 1998: 128-9; Leibfried 2000: 45). The market orthodoxy on which economic integration was founded was not challenged and European social policy was designed to provide a functional support to the process of 'market-led' integration (Goma 1996). Some commentators have even argued that the Social Dimension was being 'structurally and consciously underdeveloped' vis-à-vis economic governance in order to 'give way to the market forces, which would lead, in the end, to the restructuring of the 'expensive' welfare state' (Vanhercke 1998: 17; see also Verdun 1996: 80 and 75 cited in Pochet 1998: 68).

In parallel to the absence of discussions on the social dimension in the IGC on PU, there was virtually no reference to the potential consequences of EMU for Europe's welfare systems during the IGC on EMU. There could be several reasons for such disinterest or oversight. First, the IGCs proceeded in separate sessions which meant that EMU and PU issues were negotiated at different tables and times, and by different representatives in isolation from each other. As EMU was negotiated with representatives from economic and finance ministries, central banks and the Monetary Committee, there were few references to the challenges of EMU for social protection (Pakaslahti 1998: 52-53; Vanhercke 1998: 17). The

¹³ According to Leibfried (2000: 46), spillovers constitute the process 'by which, with the completion of the internal market – a mechanism stripped of social policy – an increasing pressure builds up on the EC to become active in social policy per se'.

¹⁴ For example, the Commission put forward a proposal whereby it called on to the Community to 'ensure that the economic and the social actually do move ahead in step'. It called for 'consistency and balance within the Treaty itself' through 'ensuring ... the social field not treated any differently from other fields' (Salais 2001: 422).

technocratic nature of the IGC precluded any linkage between EMU and social policies not only through the political and technocratic discussions but also in public debates (Pakaslahti 1998). Due to the 'core executive' character of negotiations, the negotiating teams acted in isolation from representatives of ministries that were deemed as 'sponsors of sectoral interests' such as ministers of labour and social policy (Dyson and Featherstone 1999: 13-15, 754-56). This meant that social issues would have never appeared on the table (Pakaslahti 1996; Tsoukalis 1997; Dyson and Featherstone 1999).

2.4. Conventional Expectations: EU's Asymmetric Governance and the European Social Model

Although the founding fathers had foreseen that economic integration would bring about wealth and prosperity and prepare a ground conducive to social integration, the restrictive nature of economic governance that EMU gave way to pessimistic scholarly expectations. From the 1990s onwards, it was commonplace to assume that the EU's economic governance framework was viewed as the prime source of pressure on Europe's welfare states through the Maastricht convergence criteria and the Stability and Growth Pact (Martin 1996; Rhodes 1996 and 1998; Gill 1997; Grahl and Teague 1997; Leander and Guzzini 1997; Tsoukalis and Rhodes 1997; Hay, Watson and Wincott 1999; Pierson 1999; and Hay 2000).

With respect to EMU's direct pressures on national welfare states, some argued that, given the high level of budget deficits and public debt during the early 1990s, the convergence process would necessitate radical fiscal retrenchment for EMU membership. Since social security programs are largely publicly funded and they constitute a big ticket item in total overlays, restricting deficit and debt levels would ordain diminishing resources for welfare states (Martin 1996; Rhodes 1996; Teague 1998; Pierson 1999; Bonoli, et al. 2000; Delsen, et al. 2000; Scharpf 2000). Others added that EMU, by bringing about a recessionary 'macroeconomic policy regime', would put sustained pressures on total output and employment. Falling incomes would lead to declining tax revenues out of which social expenditures are largely financed, leading to a crisis of welfare state financing (Begg and Nectoux 1995; Burkitt and Baimbridge 1995; Martin 1996; Rhodes 1996, 1998; Grahl and Teague 1997; Pierson 1999; Leibfried 2000). On top of these mechanisms, still others added that EMU would ultimately institutionalize a 'neoliberal' policy paradigm which would impose minimalist welfare states. By making social benefit costs more transparent across

the eurozone, EMU would lead to ‘social dumping’ by putting producers in high social protection jurisdictions in a disadvantaged position vis-à-vis their competitors from locations with lower social standards. In order not to lose competitiveness welfare states would face a ‘race-to-the-bottom’ in social protection, leading to rudimentary welfare states (Leander and Guzzini 1997; Tsoukalis and Rhodes 1997; Pierson 1998; Martin and Ross 1999). As such, these commentators invariably predicted that economic and monetary integration would ‘spell the death-knell’ of the European Social Model (Martin and Ross 1999: 171).

Making things worse, it was argued, the EU refrains from taking any supranational action in the social field. Many commentators expected that the ensuing loss of policy autonomy in managing exchange rates and interest rates, as well as severe restrictions on budgetary policies would result in significant curtailment of member states’ ability to sustain their welfare states. Scharpf (2002: 649) finds it unsurprising that political forces that were once relying on generous welfare states began to turn towards the EU to demand the protection of the European Social Model. The hope was that the EU would now assume the functions that nation states could no longer perform in the era of EMU. Yet while the viability of national welfare systems in Europe has been effectively undermined by an EMU designed along neo-liberal lines, the EU developed neither the competence nor the authority to compensate for this loss of capacity (Teague 1998). This view is generally illustrated by a widely cited paradox: although common European solutions are urgently needed in an environment of increasing pressures, an agreement at the EU level on matters of social policy is neither politically feasible nor effective due to the primacy of national interests, political sensitivities, and the deeply-rooted structural and institutional diversity of national welfare states that make up the European Social Model. The EU, in the eyes of many, has not taken the route of ‘positive integration’, as regulatory capacities lost at the national level through ‘negative integration’ were not re-established at the EU level (Streeck 1995; Scharpf 1996, 2000, 2002). It is widely argued, however, that unless certain EU guarantees are afforded, the European Social Model will be destroyed by the new EU economic governance.

2.5. Empirical Outcomes: European Social Model Standing up to EMU even in the Absence of a Strong Social Dimension

All member states geared towards EMU have been constrained by the pressures stemming from the Maastricht convergence criteria, in general, and the

fiscal criteria in particular. As a powerful external constraint, EMU joined a long list of endogenous pressures plaguing Europe's welfare states including adverse demographic conditions, rising costs of healthcare, and changes in domestic labour markets. Thus, the 1990s saw endless attempts at welfare reform (read: retrenchment) across the EU and these were continuously justified by reference to economic and monetary integration. Despite these attempts, however, empirical studies on welfare reform during the 1990s largely disconfirmed the retrenchment scenario.

First, with respect to social expenditures, as I show elsewhere (Bolukbasi 2006 and forthcoming)¹⁵, with the exception of a few cases, spending trajectories of European welfare states are generally characterized by continued stability.¹⁶ Although the rate of growth of social expenditures decelerated in the 1990s in comparison to those during the *trente glorieuse*, the current picture is certainly far from across-the-board downsizing as reflected in different indicators. First, levels of social spending as a share of GDP during the early 2000s remained around those of the 1990s. Remarkably, however, these levels were recorded even during a period of ever-declining total public outlays measured as a share of GDP. This meant that although total spending came under intense pressures the *share of social spending within the public budgets* had *increased* throughout. This is a sign of *increasing salience of welfare goals* within public budgets.¹⁷ At the same time, when one analyzes *social standards* in terms of real social spending corrected for the number of beneficiaries in the population, no significant decline is observed; in fact, there were some cases of serious increases. These trends hold true, even more so, in member states that faced immediate and severe fiscal pressures stemming from EMU. Thus the *absence* of major cutbacks is strikingly at odds with the conventional wisdom on the impact of EMU on the European Social Model.

Second, such lack of significant and systematic spending retreat is corroborated by comparative case studies on the impact of EMU on welfare states. These studies concurred that European welfare states have largely been resistant

¹⁵ See also Rhodes (2002) and Castles (2004) on this.

¹⁶ Operationalizing 'welfare stateness' with social expenditures is valid because the conventional wisdom on the impact of economic and monetary integration on welfare states flatly predict across-the-board cutbacks in aggregate social expenditures: especially since EMU imposed fiscal austerity, it is widely argued that curtailing the level of social expenditures would constitute an immediate aim in itself for policymakers. Moreover, since welfare states – as immense cost items in public budgets – are largely financed publicly, changes in social spending can successfully gauge the extent of cuts in entitlements and therefore can reflect retrenchment strategies.

¹⁷ There was, in other words, a striking shift away from non-social priorities towards social priorities in terms of spending. See also Castles (2004) on this finding.

to EMU-induced retrenchment pressures during the 1990s.¹⁸ For example, in their major study on the impact of EMU on the European Social Model, Martin and Ross (2004b) conclude that European welfare states have proven more resilient to EMU pressures than many analysts had anticipated. Other studies tracing welfare reform processes in general in Europe also point to a significant degree of resilience in the face of varying pressures.¹⁹ In reviewing this general literature, van Kersbergen (2000: 25) observes that while it was reported that the context of welfare state policies had changed, ‘this has not led to a dismantling of existing welfare state regimes or single programs’. Thus, retrenchment pressures have not resulted in downward convergence towards the residual welfare model as was generally expected by the conventional wisdom. On the contrary, distinct national welfare models continue to exist across Europe and largely maintain their regime characteristics. European welfare states have been undergoing a process of piecemeal and incremental readjustment, yet this observation is far from confirming the conventional expectations on the impact of the EU’s asymmetric governance on welfare states. The main conclusion of the studies that focus on social expenditures and comparative case studies, therefore, is that the European Social Model has largely ‘stood up’ to EMU pressures (Jenson and Pochet 2002: 1).

European welfare states, however, are not permanently immune to pressures emanating from the EU’s economic governance framework. Since 1999 the Stability and Growth Pact governing the final stage was supposed not only to have sustained the Maastricht’s strict fiscal straitjacket for the eurozone but also made it even tighter with the ‘close to balance or in surplus’ requirement. Although this was expected to be disastrous for the European Social Model, to the extent that political discretion would be employed in interpreting the Pact, pressures on social budgets are likely to be eased. In fact, faced with political pressures during 2002-2003, the Pact has been *de facto* suspended since November 2003. After a period of intense discussions, the recent revisions of June 2005 rendered the Pact much more flexible (see below). With the Pact’s reform its potential consequences for the European Social Model are likely to be less severe than had originally been predicted.

¹⁸ See the volume by Martin and Ross (2004a) which provides detailed case studies on continental European welfare states that were exposed to intense EMU pressures.

¹⁹ Studies that were conducted towards the end of the 1990s are broadly in agreement on this finding. For a selection of volumes presenting case studies of reform, see Esping-Andersen 1996; Bonoli, George and Taylor-Gooby 2000; Ferrera and Rhodes 2000; Kuhnle 2000; Scharpf and Schmidt 2000; Pierson 2001.

3. ECONOMIC AND SOCIAL GOVERNANCE IN THE WAKE OF THE EUROPEAN CONSTITUTION

The Constitution largely retains the asymmetric approach to economic and social governance that characterizes the EU's economic and social governance in the post-Maastricht period. While it has further consolidated EU economic governance it also brought about some promising openings in the area of social governance through deliberations in the Convention.

3.1. Further Consolidation of Economic Governance in the Constitution

The Constitution lists the activities that are related to economic governance as 'a single currency, the euro, and the definition and conduct of a single monetary policy and exchange rate policy, the primary objective of both of which shall be to maintain price stability and, without prejudice to this objective, to support the general economic policies in the Union' (Article III-177). Just like in the EC Treaty, the guiding principles are spelled out as 'stable prices, sound public finances and monetary conditions and a stable balance of payments'. Monetary policy continues to be a key area whereby the Union has exclusive competence and price stability remains as the primary objective of the ESCB (Article III-185(1)).²⁰ In fact, the IGC debated whether price stability should be an objective not only for the ESCB but also for the member states and the EU as a whole.²¹ The final text included price stability among the Union's objectives (Article I-3 (3)) but did not order the member states to pursue this directly. The ECB remains a unique institution of the EU, given its political independence which was reconfirmed in the Constitution (Article III-188). The Constitution also provides for the Economic and Financial Committee to promote policy coordination between member states, as well as to review their economic and financial situations (Article III-192). It also calls for increased coordination and surveillance of the budgetary discipline of eurozone countries (Article III-194).

With respect to the provisions concerning economic policy, the Constitution did not bring much change. Economic policies are seen as a matter of common

²⁰ The statute of the ESCB is provided in a separate protocol. Amending the protocol is not as difficult as amending the provisions in the main text.

²¹ When the Convention's draft did not list price stability as a Union objective, the ECB quickly responded that price stability had to be a Union objective given the impact of national fiscal and other economic policies on price stability.

concern, and member states are to coordinate them with the Council (Article III-179). The Constitution also reinforces the decision-making powers of eurozone members. The rules of the EDP that lay at the heart of the Stability and Growth Pact are retained in the Constitution, yet as a protocol annexed to the text.²² In addition, the Constitution strengthens the position of the Commission regarding the implementation of the EDP.²³ The political debate on the Stability and Growth Pact became extremely controversial during the period that led to the Constitution and after. The Pact was reformed in June 2005 and a significant degree of flexibility was introduced, enlarging member states' budgetary room for manoeuvre. Member states, for example, will not be subject to the EDP if they experience *any* negative growth at all (which was previously defined as -2.0 per cent of GDP). Moreover, a member state which records a temporary deficit could escape the EDP if it devotes considerable spending to some 'relevant factors' such as investment, research and development, EU policy goals, European unification, international solidarity and structural reforms including pension reforms. In particular, as for structural reforms, the Council acknowledged that member states undertaking welfare reforms may cite the short-term adverse effect of these reforms on budgetary positions as a relevant factor and thus could be exempt from sanctions. Also, among other important changes, countries will be given two years (instead of one) to correct an excessive deficit once an EDP is launched against them.

3.2. The Convention Process: Deliberating Social Governance after a Political Spillover

Opposition to active community-wide regulations on social policies remained strong throughout the Convention process. The politically sensitive nature of social policies which made the realization of the euro-corporatist vision impossible retained their salience in the Convention to the extent that when the Convention was called, there was no group convened to work on social policy provisions. The formation of the Working Group (WG) on Social Europe came only after as a *political* spillover from the discussions on economic governance.

²² The reference values of sixty per cent debt and three per cent deficit ceilings (as a proportion of GDP) introduced with the Maastricht Treaty were retained in the protocol.

²³ The Council would be able to diverge from a Commission proposal concerning the existence of an excessive deficit only by unanimous vote as opposed to the previous situation where the Council holds the authority not to accept the Commission recommendation.

When the WG on Economic Governance started to discuss the Union's values and objectives, there emerged two camps – while one group demanded an exclusive emphasis on growth and competition another proposed to strengthen the social dimension (European Convention 2002a; European Voice 7 November 2002; EUObserver 1 November 2002). Earlier in June, the European Parliament's (EP) Committee on Economic and Monetary Affairs had drafted a report with the aim of inserting references to full employment and social inclusion through the amendment of Article 2. In due course, many other proposals were tabled for amending Article 3. Apprehensive of distorting the original message of the text to be inserted, the Committee's rapporteur withdrew the proposal (Barbier 2003). After this deadlock, the WG on Economic Governance decided not to explore the social dimension. A group of members of the EP Delegation to the Convention proposed a motion calling for the creation of a working group on social policy in September. When the Convention was discussing this motion, the right attempted to keep Social Europe off the agenda altogether while the left insisted on it. The decision to establish a WG on Social Europe was eventually taken as the right could not resist a broad front of Socialists and Social Democrats despite the open resistance of the President of the Convention Giscard (EUObserver 8 November 2002; Zeitlin 2005).²⁴ The WG on Social Europe was, therefore, established in December with a mandate of determining the values and objectives of the Union. With a very crowded agenda and by far the largest membership (seventy members), the WG had a only less than two months to submit its final report (Shaw 2003).

Once the WG was established, however, the lack of a broad, uniform support for a single Social Europe surfaced in the deliberations. Christian Democrats and conservative liberals, who were in agreement with the Scandinavian Social Democrats and the British New Laborites, opposed the conferral of stronger social policy competence to the EU (Zeitlin 2005; European Convention 2003). In the final report, however, the WG could agree on rejecting the 'artificial opposition of economic and social objectives in European policy or any arbitrary hierarchical order between them' (European Convention 2003: 29) and recommended that the social values of the EU should include social justice, solidarity and equality (European Convention 2003: 6). With respect to the objectives, the WG

²⁴ The Secretariat justified the establishment of the WG by declaring that '[t]he numerous statements and contributions of members of the Convention within the plenary meetings of the Convention, the various statements of representatives of civil society, the conclusions of the Youth Convention, and the results of the Eurobarometer reflecting the expectations of the Euro-citizens ... show the need and the necessity to establish a social Europe' (European Convention 2002b: 2).

recommended that the Union should promote full employment, social justice and peace, economic, social and territorial cohesion, social market economy, quality of work, social inclusion, a high degree of social protection and efficient and high quality social services (European Convention 2003: 12). The group also agreed on ‘the need to streamline the various economic and social coordination processes’ (European Convention: 3). With respect to the division of competences between member states and the Community, the WG concluded that European action should ‘support and supplement the activities of the Member States’. Thus the existing competences at the European level were deemed adequate and therefore were not extended (European Convention 2003: 3). There was debate on how to incorporate the OMC into the Treaty. After some discussions, the WG concluded that the OMC be included in the Treaty and that the method should apply in areas ‘where coordination of national policies is provided for in the Treaty, but where the detailed arrangements are not laid down’ (European Convention 2003: 18), which included social protection and inclusion. The report, however, cautiously stated that the OMC could not be used to undermine existing Union or member state competence.

3.3. Putting Social Europe on a Firmer Footing through the Constitution²⁵

There were many openings in the area of social policy as a result of the deliberations in the WG Social Europe. Although calls for widening the primary objectives of the ECB were rejected, social values and objectives found a way to be enshrined in Articles 2 and 3. For the first time in the history of the Community, therefore, it is with the Constitution that social objectives such as promotion of a social market economy, full employment, social progress, a high level of social protection, and fight against social exclusion were inserted into the EU’s highest governance framework.²⁶

Another significant achievement is the insertion of the so-called ‘social clause’ (Article III-117) whereby the Treaty requires that in defining and implementing policies, ‘the Union shall take into account requirements linked to the promotion of a high level of employment, the guarantee of adequate social

²⁵ The articles cited in this part are from the Constitutional Treaty (European Union 2005).

²⁶ See also Kenner (2005: 548) who argues that this process represents the gradual elevation of social values within the EU’s unfolding constitutional framework. In this context, Secretary General of the European Trade Union Confederation (ETUC) John Monks claimed that the Constitutional Treaty was the ‘most social’ of all the European treaties (Agence Europe, 7 April 2005).

protection, the fight against social exclusion and a high level of education, training and protection of human health'. This horizontal clause was intended to provide the legal basis for sustaining the European Social Model. Moreover, despite the apprehensions voiced in the debate leading up to the French referendum, the Constitution, albeit modestly, rectifies the existing asymmetry between economic and social governance by striking a better balance between economic and social policies. Article III-115 emphasizes that the Union 'shall ensure consistency between the different policies and activities referred to in this Part taking *all of the Union's objectives* into account'.²⁷ In this way, this article provides an important link between the stated values and objectives on the one hand, and the policies and activities of the Union on the other. By inserting this clause, the Constitution responded to the concerns of those who supported the inclusion of social values and objectives during the deliberation process in the Convention.

At the same time, the Constitution aimed at enhancing supranational coordination in social policy. Article I-15 gives the Union general powers to coordinate economic and social policies, providing a platform for setting objectives in areas where supranational action may be required. Also, while Article III-209 states that the internal market will favour the harmonization of social systems Article III-210 stipulates that the Union shall support and complement the activities of the member states in social policy areas including social security and social protection. It is in this part that the Constitution provides for the application of the OMC in social policy without referring to it by name.²⁸ For example, Article III-213 charges the Commission with taking initiatives in close contact with the member states 'aimed at the establishment of guidelines and indicators, the organization and exchange of best practice, and the preparation of the necessary elements for periodic monitoring and evaluation'. In this context, however, the role of the Union will be confined to encouraging member states to coordinate their actions in the social policy area through the instrumentality of OMC on a voluntary basis without resorting to hard legislation (Articles III-105 and III-107). More interestingly, Article I-15(3) envisages that the Union may take initiatives to ensure coordination of member states' social policies.

Although the text is behind in terms of what the WG on Social Europe proposed, many of the suggestions of the WG, particularly those on the values and

²⁷ Emphasis added.

²⁸ Although the text does not explicitly refer to the term 'OMC', the method refers to policies aiming at promoting consultations, encouraging cooperation through studies and opinions, the setting up of guidelines, indicators and benchmarks, the use of peer review and evaluation, and exchange of best practices.

objectives of the Union, were incorporated into the final text. The Constitution laid down the foundations and the general framework of the Union's social dimension in the way that a constitution (in the proper legal sense of the term) should do. This is apparent when one compares the Maastricht Treaty and the Constitution with respect to their provisions on the relative competences of the Union and member states in social matters. The competences and the range of common policies and programs are much more clearly defined and provided for in the Constitution which may serve as the legal basis for the progressive development of the European Social Model. Moreover, the linkage between the objectives and policies are better instituted in the Constitution which contributes to a more clear definition of what constitutes 'Social Europe'.

3.4. 'Social Europe' Recast: 'Decentralized Concertation', OMC and the Constitution

Despite significant attempts at striking a better balance between social and economic governance in the EU, 'Social Europe' is not nearly on par with EMU. The Constitution, therefore, is far from resolving the long-standing asymmetry between social and economic governance in the EU. In fact, this outcome shows a striking continuity with the Maastricht process whereby erecting a supranational economic governance structure whose parameters are set by EMU had been the central project. Given the asymmetric direction of the policy process of ever-deepening economic and monetary integration with a continued under-emphasis on 'Social Europe' in the treaty structure, few have predicted that social policy goals such as sustaining pensions and healthcare and fighting against social exclusion and poverty – elements that have always lied at the centre of the European Social Model – would be reinvigorated in the EU's policy agenda (Pochet 2005). Especially towards the end of the 1990s, the socio-political context within which EMU and the European Social Model are embedded had started to evolve in a direction many had not foreseen. As the boundaries of EMU-*cum*-economic governance with other policy sectors have become 'more permeable' (Dyson 2002: 22), efforts at further integration have come to involve the incorporation of means addressing social protection alongside efforts at economic integration (de la Porte and Pochet 2002). As such, the European project can no longer be characterized by a 'single purpose' emphasizing exclusively economic and monetary goals (Hemerijck 2004).

In a way, these developments are a response to common concerns over the state of social protection in the EU. Articulating these concerns within the context

of a common political approach was all the more possible at the height of the 'social democratic moment' during the second half of the 1990s when social democratic parties gained power in European capitals. At the EU level, earlier elements of this vision had been engrained in the White Paper on *European Social Policy* (European Commission 1994) which held that while Europe's welfare states are to be 'restructured' for long-term sustainability of the programs, social protection levels should be 'maintained'. It is this common approach that made the Lisbon Agenda possible whereby social protection is increasingly seen as a 'productive factor' which is repeatedly echoed in the Spring European Council meetings.²⁹

With respect to the nature and role of 'Social Europe' envisioned in this process, due to the recognized welfare diversity among member states and persistent political opposition to a euro-corporatist pan-European social policy, this common approach seems to follow the alternative route towards a 'decentralized concertation' vision. In this view, the primary role of Social Europe is envisioned to be one of supporting and coordinating welfare state activities at the national level while connecting welfare diversity within the European Social Model (Sakellariopoulos, et al. 2004). Thus the historic goal of the left of achieving a Social Europe as a regulatory counterbalance to the EU's economic governance through replicating redistributive structures and policies of constituent national welfare states at a pan-European level is, once again, largely written off on the road to the Constitution. Decentralized concertation seemed to remain the only politically feasible outcome at the Convention where a political balance is struck between the desire of member states to retain ultimate control in social policy on the one hand, and realities of economic integration that require increasing cooperation at the EU level on the other; and between the left pressing for a euro-corporatist Europe on the one hand, and strange bed-fellows of the right and Scandinavian Social Democrats on the other.

In terms of the main method of achieving Social Europe as such, there is ongoing dialogue between EU institutions and member states. In this dialogue, rather than setting uniform, binding standards and rules above and beyond the nation state, the EU is expected to create a forum for discussion and mutual learning through the OMC, whereby it would assume the role of coordination in areas where member states deem useful and where gaps cannot be filled by national-level policies alone. In this context, the OMC is hoped to function as a complement to the *acquis* as a possible 'route forward' in areas where member

²⁹ In a way, it was made possible through the perceived limits of the adverse impact economic and monetary integration has come to have on processes of 'social dumping' and 'race-to-the-bottom' in social protection and standards during the 1990s.

states cannot yet agree on a common policy but nevertheless share the political will to make progress in those areas (de Burca and Zeitlin 2003). At the same time, the ‘legitimate diversity’ within the European Social Model – generally seen as an impediment for the euro-corporatist vision – is viewed as an opportunity for improving national standards through converging on best practices and setting policy goals towards a common political vision (Scharpf 2003; Hemerijck and Berghman 2004; Pochet 2005; Zeitlin 2005). Consistent with the decentralized concertation vision, this method encourages the convergence of national objectives, performance, and approaches rather than specific rules, institutions and programs. It aims at identifying common concerns and advancing interests of member states while simultaneously respecting their autonomy and diversity (Zeitlin 2005). With the encouragement of the EU and their peers, member states would pursue a common set of objectives while retaining the capacity to restructure their welfare states and fending off any pressures emanating from European integration.

It is generally argued that the implementation of this method is particularly appropriate in policy areas where policy-making is complex and the issue is domestically sensitive. Thus, the OMC is expected to prove effective in the area of social policy where diversity and disagreement among member states preclude harmonization. While the effectiveness of the OMC in different policy areas is an empirical question, the deliberative nature of the method points to a very powerful condition: the OMC can be effective when it builds on existing preferences of the more powerful decision-makers, be it a group of member states or a constellation of other actors. It can thus serve to advance Social Europe when there is political will in that direction at the national level.

4. CONTINUED ASYMMETRY IN EUROPE’S EMERGING GOVERNANCE AND THE EUROPEAN SOCIAL MODEL

Although the post-Maastricht developments that culminated in the launching of the Lisbon agenda may be seen as efforts at embedding economic governance increasingly in social integration, they are still relatively loosely anchored within the European institutions and their standing in the current treaty structure remains rather weak especially after the ‘non’. In the meantime, efforts at strengthening Social Europe coincided with initiatives seeking a better policy mix in the EU’s economic governance. The latter resulted in a gradual ‘taming’ of the Stability and Growth Pact which has been a chief source of concern for the European

Social Model's future. Nevertheless, attempts in both directions have not sufficed in tilting the current (im)balance to any significant degree in European governance. Therefore, while the Lisbon Agenda, which has been variously described as a 'true watershed' (Esping-Andersen et al. 2002) or a 'turning point' in the Europeanization of social policy (Ferrera, Hemerijck and Rhodes 2000), could have been institutionalized (however weakly) through the Constitution, it falls much short of amounting to 'Europe's Maastricht for welfare' (Rhodes 2000) given the stark asymmetry that characterizes the EU's economic and social governance.

The EU's asymmetric governance characterizing the Maastricht Treaty and the Constitution, however, need not necessarily lead to apprehensions over the future of the European Social Model as this paper aims to show. First, although the highly asymmetric Maastricht Treaty that institutionalized EMU with no parallel provisions for building a social dimension was expected to tear to pieces the very fabric of the European Social Model, this doomsday scenario has not been borne out by the evidence on welfare state trajectories in the 1990s. Second, while the Constitution retained the asymmetry, recent revisions in the EU's economic constitution and the emerging social governance in the EU culminating in the institutionalization of the Lisbon Agenda and the OMC in the Constitution indicate that a firmer platform for debating the future of the European Social Model is in now place. Conceived within the only politically feasible 'second-best' alternative of decentralized concertation, this platform depends on how far member states want to go in strengthening the European Social Model. The very absence of a Social Europe designed along the lines of the euro-corporatist vision, however, should not lead to foregone conclusions on the future of the European Social Model.

In fact, as the Eurobarometer results indicate, it seems it was due in large part to the perceived inadequacy of a Social Europe designed along the lines of decentralized concertation vis-à-vis the deeply institutionalized EMU that the French electorate seems to have reacted to the Constitution. Moreover, a majority of both the French and Dutch citizens have reported that they expect the negative referendum results would facilitate the adoption of a Constitution that emphasizes 'Social Europe', one that would probably be designed along the lines of the euro-corporatist vision. It seems, at least on one reading, that one central message of these referenda is that at least the French desire a Social Europe beyond what member states and members of the Convention were readily prepared to agree on. However, it should be remembered that although the Constitution did not break new ground in social policy, as the first attempt to incorporate a real discussion on social issues it managed to 'slip the thin edge of the wedge into the crack that

might become Social Europe' to say the least (Baldwin 2005: 3). In the final assessment, however *socially desirable* may a Social Europe along euro-corporatist lines be, given the absence of *politically feasible* alternatives to decentralized concertation, the rejection of the Constitution was an 'own goal' for the French left as Baldwin (2005: 3) observes.

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STATES AND THE EXERCISE OF POWER IN THE NEW EUROPEAN UNION

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ABSTRACT

In this paper we adopt a game-theoretic approach to analyze legislative bargaining of small and large member states in the Council of the European Union (EU). Our model shows that small member states tend to support different types of legislative acts in the Council than large member states. All other things equal, small member states strive to adopt acts that have few ambiguities and describe extensively how the act is to be applied, whereas large member states advocate the adoption of acts in which certain matters have been left open-ended deliberately. By backing acts that leave few ambiguities, small members states intend to curb the scope for Council involvement as to application decisions, while large member states intend to enhance the discretionary power of the Council in the application phase. We show that several recent developments surrounding the Stability and Growth Pact can be understood in light of the model.

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1. INTRODUCTION

In this paper we analyze strategic behaviour of individual member states in the Council of the European Union (EU). We introduce a model that shows that small and large member states aim at advancing different types of legislative acts. All other things equal, small member states advance acts that are specific and detailed ('complete contracts'). By contrast, large member states seek to adopt acts that are more vague and open-ended ('incomplete contracts').

By adopting different types of legislative acts, member states ensure that the discretion in the application stage of the act lies with different EU institutions. By adopting acts that are specific and detailed, small member states reduce the scope for discretion in the application phase of EU legislative acts and effectively delegate execution of the acts to the Commission. In contrast, large member states prefer vague and open-ended arrangements to strengthen the discretionary role of the Council. Large member states have more power in the Council.

The model of this paper assumes that member states in the Council bargain over new EU legislative acts proposed by the Commission at two distinct points in time. *Ex ante* member states decide whether a legislative *act* will be adopted, and, if so, whether the act is formulated as a *complete* or an *incomplete* contract. A complete contract is comprehensive and specific and stipulates exactly how it is applied in all future contingencies. By contrast an incomplete contract leaves certain ambiguities so that application decisions become non-trivial. *Ex post*, that is, in the application phase of the act, member states in the Council enter a 'renegotiation stage' in case the act is formulated as an incomplete contract. The Council may also have to renegotiate the act in case it is formulated as a complete contract, however this happens only if the Commission proposes to replace it by a new act.

In our model an incomplete contract has the advantage that it implies flexibility, and thus that *ex post* renegotiation in the Council is swifter and less costly. Yet, there is also a downside to flexibility. *Ex post*, individual member states may attempt to block Council decisions that are beneficial for the EU as a whole. Both small and large member states display this type of opportunistic behaviour. However, the option to block decisions in the Council is more valuable to a large member state than a small one because the large member state has more voting power in the Council. The model hence shows that the difference in payoff between an incomplete contract and a complete contract is larger for a large member state than for a small member state. This is why in reality large member states will more often lean towards acts formulated as incomplete contracts, while small member states more often favour acts formulated as complete contracts.

Through a complete contract small member states buy insurance against ex post opportunistic behaviour of large member states.

Our model builds upon recent advances in contract theory, particularly the theory of *incomplete contracts* (e.g. Hart 1995 and Hart and Moore 1988). It is well-known that legislation can be seen as an incomplete contract (e.g. Doleys 2000, Persson 2002). The perspective that the degree of incompleteness is a *choice variable* is new, but it is closely related to formal models that endogenize the degree of discretion an Agent has when being delegated a task by a Principal. For examples in the EU context, in which the Agent is the Commission, see e.g. Franchino (2000, 2005). Unlike Franchino we do not treat the EU member states as a single actor and show that large and small member states may have different preferences as to the choice of the degree of discretion of the Commission. Finally, Schure and Verdun (2006) explore questions that are closely related to the ones we study here, however in the context of a different and richer model. In their model the Council jointly decides (1) whether the act is a complete or incomplete contract, and, if the act is an incomplete contract, (2) whether or not to delegate the discretionary power to the Commission. It turns out that in this more general model, both small and large member states favour incomplete contracts, however they disagree about the delegation decision. Small member states wish and large member states wish not to delegate the discretionary power to the Commission. In this setting there may be also medium-sized member states and these support the adoption of complete contracts by the Council.

Our model predicts a general trend in the behaviour of member states in the EU assuming all other things equal. The legislative acts this paper applies to are only those acts that may require further future decisions ('application decisions') at the EU level. The EU legislative acts that satisfy these criteria are typically regulations and EU treaties (i.e. treaty articles and protocols). The model does not apply to the creation of directives, as discretion at the implementation stage with directives is dealt with at the national level. In addition our model only applies to acts where member states face considerable uncertainty regarding their national interest in the future.

In theory the implementation of a complete contract should be trivial in terms of execution. In practical terms, implementation decisions of 'complete contracts' in the EU are often – but not always – delegated to the Commission. Incomplete contracts often require additional Council decisions. In the EU, incompleteness of legislative acts in the sense of our model can take on the following forms: 1) provisions that expressly require the Commission to make proposals to the Council regarding application decisions; 2) 'expiry dates' on acts after which a

new Council decision is needed; 3) vague language so that the Commission has to refer the matter to the Council to obtain a mandate at the application stage.

Let us consider a specific example. On 25 November 2003 the Council of the European Union (EU) of Ministers of Economic and Financial Affairs (Ecofin) decided to suspend temporarily the Stability and Growth Pact (SGP) for the cases of France and Germany. These two countries were running high budgetary deficits, and the SGP (in particular the Excessive Deficit Procedure) stipulates that at some point in time sanctions be placed on these countries. The Netherlands, a small EU member state, urged the Commission to take the Council to the European Court of Justice (ECJ) and challenge that Council decision of 25 November 2003.² The initiative of the Netherlands was remarkable because the Dutch government at the time knew it was itself going to violate the three per cent excessive deficit rule very shortly thereafter, and thus risked facing the penalties stipulated in the SGP itself. In our view, the Netherlands was attempting to curb the ability of the Council to bend the excessive deficit rule *ex post*. Indeed, the model of this paper explains the paradoxical behaviour of the Netherlands as fully rational.

The structure of the paper is as follows. In the next section we argue that the Treaty of Nice and ‘enlargement’ have made our model more relevant because these changes have increased the scope of qualified majority voting in the Council and also increased the contrast between individual large and small member states because of an increase in voting power of large member states *vis-à-vis* smaller member states. Sections three and four present the model and an example of it. Section five turns to a discussion of recent developments related to the Stability and Growth Pact and shows how they can be understood in light of the model. The final section concludes.

2. VOTING IN THE EU COUNCIL: BEYOND CONSENSUS

Decision-making in the European Union has undergone a number of changes since the Single European Act (SEA) introduced qualified majority voting (QMV) in the Council. The 1992 Treaty on European Union (the ‘Maastricht Treaty’) extended QMV into more areas of policy making. The fourth Enlargement of EU (with Austria, Finland and Sweden joining on 1 January 1995) was based on the Maastricht Treaty and only marginal changes were made (the new member states

² Note that the Netherlands has had a tradition of ensuring the Commission’s role is not undermined by the Council or by large member states (see for example Maes and Verdun 2005).

were merely given their share of votes in the Council, Commissioners and seats in the European Parliament). However more fundamental institutional changes needed to be made before a next enlargement could take place in which a large number of Central and Eastern European Countries (CEECs) and smaller Mediterranean states could eventually join. The Intergovernmental Conference (IGC) that resulted in the Treaty of Amsterdam (1997) dealt with many of these issues, yet was unable to settle all of them. What became known as the 'Amsterdam-leftovers' were dealt with in the fifth IGC that led to the Treaty of Nice.

As is well-documented (Wessels 2001; Laursen 2005; Maurer 2005) the 2001 Nice Treaty (which entered into force in February 2003) represented a compromise package that solved a few of these matters in a haphazard fashion, but pushed other matters to the future. These issues were subsequently the subject of discussion in the Convention which came up with a draft *Treaty Establishing a Constitution for Europe* in the summer of 2003. The European Convention aimed at creating a Constitution that was simplified and in which there would be fewer veto points and which would resort more frequently to simple majority voting (see Crum 2005). The Constitution was eventually approved in June 2004 after a few changes were made following the Summit in December 2003 that had failed to accept it.³ The two negative referenda put into question whether the Constitution will ever be adopted in its present form. Yet it is not unlikely that parts of it will be adopted gradually.

For the purpose of our paper let us look at how the weights of the votes in the Council have been distributed in the EU (see table 1). What is immediately clear is that the weighting of the votes of the larger member states has increased in recent years and was increased further in the Constitutional Treaty. For example, on average the weights of the votes per member state increased by a factor of $237/87 = 2.7$ with the Treaty of Nice. However the weights of the votes of the

³ Heads of State and Government were unable to find sufficient common ground between, in particular, Spain and Poland on the one hand, and Germany on the other, on the issue of voting in the Council. A few important changes were made. The 2003 text of the draft Constitutional Treaty recommended that a law could be adopted if a majority (50 per cent) of member states representing 60 per cent of the population would support it. The revised text, adopted in June 2004, stipulated that a law will be passed if 55 per cent of the number of member states representing 65 per cent of the population approves it. There are numerous other changes to the draft Constitutional Treaty which we will not list here. Suffice to say that the revised text postponed the starting date of the many of the institutional changes called for by the July 2003 draft Constitutional text (e.g. size of the Commission) and scrapped others (the rotating presidency of Council of Ministers will not be abandoned). Note that the treaty will only enter into force if ratified by all member states, which has been put into question by the negative referenda outcomes in spring 2005 in France and the Netherlands.

large countries increased by more: Germany, France, Italy and UK went to 29 from 10, an increase by a factor 2.9. According to the text of the Constitutional Treaty in June 2004 the voting weight of individual large member states in the Council would increase further since the size of their populations count as the main weight (for a proposal to pass would require a 55 per cent majority of the member states representing at least 65 percent of the population of the EU).

What does the academic literature on voting in the Council tell us about who wins and loses and what strategies are adopted? The literature on EU governance, decision-making and voting in the Council is enormous. There are qualitative policy analyses which discuss why a certain policy was adopted, but there are also many quantitative studies and formal models that study voting in the Council based on relative weight and voting coalitions. The first type of analysis often reflects on specific situations in a policy-making field (environment, telecommunications etc.), whereas the latter usually studies the process across larger range of policy areas. Our paper fits in this latter body of literature.

Whether changes in formal voting rules actually have (or will have) an effect on the legislative outcome is still a matter of debate. Nurmi and Hosli (2003) support our assumption that the re-weighting of votes among the member states will have as the effect that the ‘culture of consensus’⁴ will be impractical in the enlarged EU (Nurmi and Hosli 2003: 37). Mattila and Lane (2001) also examine voting practices in the Council and offer explanations as to why there is more frequent unanimity voting than one might expect by merely looking at voting procedures. Part of the answer is vote-trading; another might be that the preference of Council members might be far from the status quo point (thus non-decision would be more costly than compromising). They do however suggest that the enlargement process might change the spirit of unanimity in the Council and that there would be increased voting in the Council (Mattila and Lane 2001: 49).

Hug (2003) examines how discussions in the Convention led to a reconceptualization of the governance structure of the European Union. Without a significant transfer of sovereignty to the European institutions, the governance structure will remain between that of an international organization and a federal state. Thus, power struggles between the Commission and the Council and between the member states and European institutions will continue. Our paper is complementary to these analyses in that it presents specific predictions in this new environment.

⁴ Jon Golub (1999) explains what the ‘culture of consensus’ means in practical terms. He finds that actual voting the Council occurs much less frequently than one would expect based on the formal rules.

Table 1. Weighting of Votes in the Council Prior to and after the 2001 Nice Treaty (March 2005).

	Before Nice	After Nice (today)	Draft Constitution
Member Countries			Weight times pop.
Belgium	5	12	1*10
Denmark	3	7	1*5
Germany	10	29	1*82
Greece	5	12	1*10.5
Spain	8	27	1*40
France	10	29	1*58
Ireland	3	7	1*3.6
Italy	10	29	1*58
Luxembourg	2	4	1*0.4
Netherlands	5	13	1*16
Austria	4	10	1*8
Portugal	5	12	1*10
Finland	3	7	1*5
Sweden	4	10	1*9
United Kingdom	10	29	1*58
Sub-total:	87	237	371
Candidate Countries (as of March 2005)			
Bulgaria		10	1*8.5
Cyprus		4	1*0.7
Czech Republic		12	1*10
Estonia		4	1*1.5
Hungary		12	1*10
Latvia		4	1*2.6
Lithuania		7	1*3.7
Malta		3	1*0.4
Poland		27	1*38.5
Romania		14	1*23
Slovakia		7	1*5
Slovenia		4	1*2
Total		345	478
Qualified Majority	62	232	Simple Majority of MS + 3/5 population

Source: Treaty texts (adapted by authors).

Focusing on the actual decision-making in the EU that took place over the past years, Stokman and Thomson (2004) argue that procedural models suggest

that the formal procedure of the decision-making process which is to be followed (e.g. co-decision, assent, etc.) is crucial to understanding the outcome. In contrast, informal bargaining models, such as the compromise model (in which actors try to find a cooperative solution that takes into account the interests of all actors) or the position exchange model (in which pairs of actors take advantage of situations in which both gain by supporting each other's position on the issue that is relatively more important to the other) treat the procedure largely as a black box. Overall, they find that bargaining models, and in particular the compromise model, do much better than procedural models in generating accurate forecasts (Stokman and Thomson 2004: 19, see also Arregui, Stokman and Thomson 2004). They argue that positions of actors shift in EU decision-making, but that these shifts occur during the bargaining process in reaction to exchange and/or so as to enable a compromise (Stokman and Thomson 2004: 69).

Bailer's study of bargaining in the Council looks at the influence of endogenous and exogenous sources of influence (Bailer 2004). 'Endogenous power resources' include the extremity of the position a member states picks on a policy matter, and closeness to the agenda setting process of the Commission. 'Exogenous power resources' are, for instance, voting weight and economic strength. Bailer finds that endogenous resources are important to predicting bargaining outcomes, and that exogenous resources are only helpful predictors in certain policy areas. In our model we assume implicitly that member states have identical endogenous resources.

3. THE MODEL

Our model is a stylized game-theoretic model of EU decision-making that stresses the role of the Commission and the Council in deciding on new EU legislative acts.⁵ We distinguish two points in time at which the Commission and the Council take decisions regarding a legislative act. *Ex ante* the Council decides on a new act proposed by the Commission. The *ex post* decision regards whether and how exactly the act will be applied. Throughout the model we assume that the Commission is 'benevolent' and only makes proposals that are considered 'good'

⁵ Our argument for only including the Commission and the Council is not that the role of other institutions, such as the European Parliament, is marginal. Rather, we argue that the intuition to our theory is best understood in a simple framework and does not change when modelling EU decision making in a more realistic way.

for the EU as a whole.⁶ In reality, of course, power struggles between member states and other matters such as personalities are important for Commission decisions. However, we view as realistic the assumption that Commissioners will protect the interest of the EU (rather than that of a particular member state).

We initially do not explicitly model the voting game governing Council decisions, but assume that the voting outcome of the Council is probabilistic. Moreover, in line with the literature on voting power in the Council, we assume that the probability is higher that a large member state is in a winning coalition or a blocking minority than a small member state. In the next section we back up these assumptions by providing an example in which we explicitly model the ex post Council voting game. In the example we assume that member states' attitudes to a given proposal are probabilistic and that the voting game is non-cooperative.

A central assumption of our model is the aspect of intrinsic uncertainty regarding the 'benefits of the legislative act'. This assumption captures the fact that the member state attitudes towards the act may change between the *ex ante* and *ex post* decision moments. In the case of the Stability and Growth Pact (SGP) (i.e. EC 97/C 236/01) this happened, for instance, in Germany. Germany strongly supported the SGP at its inception, but actively opposed its enforcement in the fall of 2003. More generally, any legislative act that is considered beneficial *ex ante* may turn out harmful *ex post*, both for individual member states and the EU as whole. Changes in the economic outlook in the EU may be one of the factors that can trigger a change in position. We model uncertainty by a choice of a player called *Nature*. A draw of Nature may determine that a legislative act that was accepted *ex ante* by the Council may be contended *ex post* by one or more member states or the Commission.

Our framework builds upon recent advances in contract theory, particularly the theory of *incomplete contracts* (e.g. Hart 1995 and Hart and Moore 1988). New EU legislative acts may take the shape of either a *complete contract* (i.e. a contract that is comprehensive and specific when it comes to the future moments when the particular legislative act is applicable) or an *incomplete contract* (i.e. a contract that is vaguer when it is actually applied). We will illustrate in section 5 that the Stability and Growth Pact is an example of such an incomplete contract.

In reality, contractual incompleteness is a matter of degree and difficult to pin down. To make the concepts of complete and incomplete contracts concrete and

⁶ For simplicity we assume that preferences of member states and the Commission are binary and are either 'good' or 'bad'. In reality preferences are obviously not on a binary scale. In fact, Stokman and Thomson (2004) show that relative importance of member states' positions may provide additional information as to coalition formation.

testable, we will slightly abuse these terms and translate them as follows. We assume that in case the legislative act is formulated as a *complete contract* the Commission has the authority to take care of its application *ex post* (i.e., the Council need not be involved). This assumption is natural if the act were a true complete contract, because complete contracts do not contain any ambiguities, so that applying the act is merely a matter of execution, i.e. the task of the Commission. We assume that if the legislative act is formulated as an *incomplete contract* the Council has to be involved when it comes to application decisions. This will indeed be the case if the act is sufficiently vague, but also in case a role for the Council is explicitly stipulated, or if the act expires before an application decision is to be taken (the contract is short-term).

Above we have assumed on the one hand that complete contracts are specific as to their application, while on the other hand the attitudes towards an act may change between the *ex ante* and *ex post* decision moments. If, in our model, the Commission wished to not apply an act that was written up as a complete contract it may submit an amendment to that act to the Council. In contract theory such a situation is called *renegotiation*. In case the act is written up as an incomplete contract a second bargaining stage (which we shall also term ‘renegotiation stage’) always takes place.

The details of the model are given in Figure 1 below. Ex ante the Commission proposes an act to the Council. The Council can reject the act, accept the changes as an incomplete contract, or accept the act as a complete contract. If the act passes, Nature next makes its draw regarding the ex post attitudes of the Commission and the member states towards the act. In Figure 1 we only make the preferences of member state i (MS_i) and the Commission explicit, which leaves us with four options. The act can be (in spirit) (1) good for both the EU and MS_i , (2) good for the EU, but bad for MS_i , (3) bad for the EU, but good for MS_i , (4) and bad for both the EU and MS_i . In case the act is formulated as an incomplete contract the Council next has to decide whether to act in accordance with the spirit of the act, or ‘bend the rules’.⁷ In case (1) above, neither the Commission nor MS_i would like the rules to be bent, but they may be outvoted by other member states in the Council. Assume, therefore, that in case (1) the rules are bent with probability \underline{P}_i . Let us denote the probabilities that the rules are bent in cases (2), (3), and (4) by \underline{P}_i , \overline{P}_i , and $\overline{\overline{P}}_i$, respectively. We make the natural assumption

⁷ Recall the assumption made above that the rules can be bent so much that it is never necessary to renegotiate and amend the legislative act written up as an incomplete contract.

that the more support there is for bending the rules, the larger is the probability that the Council will indeed decide to bend the rules:

$$\underline{\underline{P_i}} < \underline{P_i} < \overline{P_i} < \overline{\overline{P_i}} \quad (1)$$

We also assume that large member states have more leverage in the Council. In particular, we assume

$$\underline{\underline{P_i}} < \underline{\underline{P_j}} \quad \underline{P_i} > \underline{P_j} \quad \text{for all } i \in L \text{ and } j \in S \quad (2)$$

$$\overline{P_i} < \overline{P_j} \quad \overline{\overline{P_i}} > \overline{\overline{P_j}} \quad \text{for all } i \in L \text{ and } j \in S \quad (3)$$

Here L and S represent the sets of large and small member states, respectively.

In case the act is formulated as a complete contract the ex post bargaining game is different because the Commission has the authority to execute the act as it was crafted ex ante. Thus, in case the act turns out (1) good for both the EU and MS_i or (2) good for the EU, but bad for MS_i the Commission will not propose an amendment and apply the act as is. Only in the cases that the act turns out (3) bad for the EU, but good for MS_i , or (4) bad for both the EU and MS_i will the Commission propose an amendment to the Council. Figure 1 makes clear that we assume in these cases that the Council changes the act with exactly the same probabilities as it bends the rule in case of the incomplete contract.

Finally, we need assumptions regarding the payoff of the decision for MS_i to make a meaningful comparison between the two types of contracts. Assume that the benefits to MS_i are B_i in case the decision falls in line with the preferences of MS_i , and that MS_i suffers a cost of $C_i = 0$ if the decision goes against the will of MS_i . B_i and C_i are pecuniary measures for the benefit and costs to MS_i of the possible decision outcomes. The assumption that $C_i = 0$ is merely a normalization. We also allow there to be costs attached to ex post bargaining. We again normalize the costs of renegotiating an incomplete contract to zero since it does not involve a reformulation of the legislative act. Renegotiation of a complete contract is more involved (and may actually lead to reputation loss for the EU), hence, we assume that replacing a complete contract by a new one costs

$C_i^R = \alpha B_i$ for all member states i . The assumption that the renegotiation costs of a complete contract is proportional to its benefits is convenient, but also realistic, as both are in practice related to a common factor, for instance the Gross Domestic Product (GDP) of the member state.

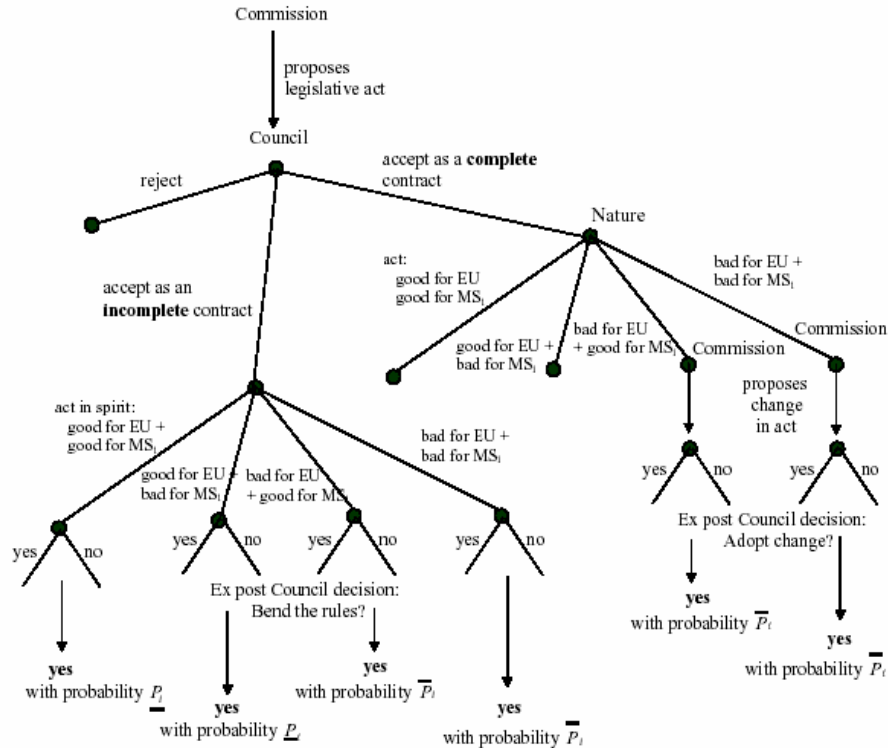


Figure 1. Stylized model of EU decision making after Nice.

Let us next analyze the model. Absent actual information of the power structure in the Council we cannot derive the actual ex ante Council decision. However, we can derive what are the preferences of each member state regarding the act ex ante. Proposition 1 below shows that large member states obtain higher expected payoffs from the adoption of legislative acts than small member states. This result holds simply because large member states have more leverage in the Council (equations (2) and (3)) when it comes to application decisions. Thus, the result applies both for acts that are complete contracts and acts that are incomplete contracts.

Proposition 1. Large member states obtain greater benefits from the adoption of legislative acts than small member states.

Proof. The proof uses equations (2) and (3). First, consider the adoption of an incomplete contract. The expected payoff of an incomplete contract for a member state i is given by:

$$\Sigma_i^{IC} = \left[\pi_1(1 - \underline{P}_i) + \pi_2 \underline{P}_i + \pi_3(1 - \overline{P}_i) + \pi_4 \overline{P}_i \right] B_i$$

It is easy to verify from equations 2 and 3 that $\Sigma_L^{IC} > \Sigma_S^{IC}$. The payoff of a complete contract is given by:

$$\Sigma_i^{CC} = \left[\pi_1 + \pi_3(1 - \overline{P}_i - \alpha) + \pi_4(\overline{P}_i - \alpha) \right] B_i$$

It is again easy to verify that $\Sigma_L^{CC} > \Sigma_S^{CC}$. Q.E.D.

Proposition 2 below is the main result of our paper. It implies that if some, but not all, member states support adopting an act as an *incomplete* contract these must be the large member states. Also, if some, but not all, member states support adopting an act as a *complete* contract these must be the small member states.

Proposition 2. The difference in the payoff between an incomplete contract and a complete contract is larger for large member states than for small member states.

Proof. The proof is again trivial and it hinges only on equation (2). A member state i favours adopting the act as incomplete contract if

$$\begin{aligned} \Sigma_i^{IC} &= \left[\pi_1(1 - \underline{P}_i) + \pi_2 \underline{P}_i + \pi_3(1 - \overline{P}_i) + \pi_4 \overline{P}_i \right] B_i > \\ \Sigma_i^{CC} &= \left[\pi_1 + \pi_3(1 - \overline{P}_i - \alpha) + \pi_4(\overline{P}_i - \alpha) \right] B_i \Rightarrow \\ &-\pi_1 \underline{P}_i + \pi_2 \underline{P}_i + (\pi_3 + \pi_4)\alpha > 0 \end{aligned} \tag{4}$$

Equation (2) shows that the left-hand side of the inequality in equation (4) is larger for large member states than for small member states. Q.E.D.

Equation (4) in the proof to Proposition 2 summarizes the considerations of a member state MS_i in the *ex ante* negotiation stage. A disadvantage to MS_i of formulating the act as an incomplete contract is that it is renegotiable in case both MS_i and the Commission are satisfied with it *ex post*. An advantage to MS_i is that the act is potentially renegotiated in case MS_i is not satisfied, while the Commission is. In case the act turns out bad according to the Commission, the Council will have to renegotiate independently of whether the act was formulated as a complete contract or an incomplete contract. However, in this case the incomplete contract would be better since renegotiation is cheaper.

4. AN EXAMPLE WITH NON-COOPERATIVE VOTING

To make our model more concrete let us make the *ex post* voting game explicit in a stylized example. Assume there are ten small member states, each with a single vote, and one large member state with two votes. The example could easily be altered to describe different compositions of member states and voting weights, however the message would stay the same (see e.g. Schure and Verdun 2006).

After the act has been accepted *ex ante* Nature picks the *ex post* preferences regarding the act. We assume that member state preferences are picked from independent Bernoulli trials; for each member state i the act turns out ‘good’ with probability p_σ and ‘bad’ with probability $1 - p_\sigma$. Thus, should it come to an application decision in the Council *ex post*, a member state casts a vote in support of applying the act with probability p_σ and supports renegotiation with probability $1 - p_\sigma$. The probability p_σ may depend on whether the act is good for the EU as a whole, i.e. $\sigma = G$, or bad, $\sigma = B$. If so, it is natural to assume that $p_G \geq p_B$. Assume that Council decisions are adopted by a qualified majority vote. Specifically, since there are twelve votes the act is applied without modification *ex post* if it attracts $12 * q$ or more votes, where q is the qualified majority threshold.

We can derive the probabilities $\underline{\underline{P}}_i, \underline{\underline{P}}_i, \overline{\overline{P}}_i, \overline{\overline{P}}_i$ as follows. If i is the large country we get $\underline{\underline{P}}_L = 1 - \Pr\{X \geq 12 * q - 2\}$, where X follows a binomial

distribution with $n=10$ draws and a probability of success of p_G .⁸ For a small country we obtain $\underline{P}_S = 1 - \Pr\{Y + Z \geq 12 * q - 1\}$, where Y follows a binomial distribution with $n=9$ and a probability of success of p_G , and Z becomes 2 with probability p_G and 0 otherwise. We can also show that $\underline{P}_L = 1 - \Pr\{X \geq 12 * q\}$ and $\underline{P}_S = 1 - \Pr\{Y + Z \geq 12 * q\}$. The other probabilities can be computed in a similar fashion.

In general we have $\underline{P}_L \leq \underline{P}_S$ and $\underline{P}_L \geq \underline{P}_S$, i.e., large member states have more leverage in the Council. In practice the probabilities \underline{P}_L and \underline{P}_S , and also \underline{P}_L and \underline{P}_S can lie quite far apart. For instance, in case $p_G = 3/4$ and $q=2/3$ we obtain $\underline{P}_L \approx 0.08$, $\underline{P}_S \approx 0.14$, $\underline{P}_L \approx 0.47$ and $\underline{P}_S \approx 0.30$. Thus, in case a large member state supports applying the act without any changes *ex post* it will be in a winning coalition with about 92 per cent chance. A small country supporting the act will only win with about 86 per cent probability. Moreover, in case a large member state would like to see the act changed *ex post* it will successfully block its application in about 47 per cent of all Council votes, compared to about 30 per cent for a small member state.

Proposition 2 shows that large member states are more prone to propose to adopt the act as an incomplete contract than small member states *ex ante*. Let us extend the example above to show this numerically. Assume the act turns out to be good for the EU with probability $4/5$. Recall that if the act is good for the EU as a whole, then individual member states support it *ex post* with probability $p_G = 3/4$. Assume that member states only support the act with probability $p_B = 2/5$ in case the act is bad for the EU as a whole. In this example the large member state backs the incomplete contract because:

⁸ Recall that individual member states vote in support of applying the act from a series of ten independent Bernoulli trials with a probability of ‘success’ of p_G . The total number of supporting votes of the ten small member states hence follows the binomial distribution above. The large member state supports the act so that it will cast its two votes in favour. The act is thus applied as it was crafted in advance in case $X + 2 \geq 12 * q$, i.e. with probability $\Pr\{X \geq 12 * q - 2\}$. The rules are bent with probability $1 - \Pr\{X \geq 12 * q - 2\}$.

$$-\pi_1 \underline{P_L} + \pi_2 \underline{P_L} + (\pi_3 + \pi_4)\alpha = -\frac{4}{5} * \frac{3}{4} * 0.08 + \frac{4}{5} * \frac{1}{4} * 0.47 + \frac{1}{5}\alpha \approx 0.048 + \frac{1}{5}\alpha > 0$$

By contrast, a small member state prefers the complete contract provided that the renegotiation costs are small enough:

$$-\pi_1 \underline{P_S} + \pi_2 \underline{P_S} + (\pi_3 + \pi_4)\alpha = -\frac{4}{5} * \frac{3}{4} * 0.14 + \frac{4}{5} * \frac{1}{4} * 0.30 + \frac{1}{5}\alpha \approx -0.022 + \frac{1}{5}\alpha$$

It turns out that for $\alpha \leq 0.11$ the equation above is smaller than zero, that is, a small member state prefers the complete contract if the renegotiation costs are eleven per cent or less of the potential benefits B_i of the act.

5. THE CASE OF THE STABILITY AND GROWTH PACT

The Stability and Growth Pact (SGP) was finalized in June 1997 to support sound fiscal policies in member states once Economic and Monetary Union (EMU) entered into the third stage (the introduction of the euro in financial markets on 1 January 1999 and the circulation of euro banknotes and coins in the eurozone as of 1 January 2001). EMU contains a new supranational institution responsible for monetary policy, but leaves budgetary and fiscal policies in the hands of national member states. The SGP consists of two Council Regulations and a Council Resolution.⁹ It strengthens, speeds up, and makes more explicit the so-called excessive deficit procedure (EDP) that is stipulated in Article 104 (Treaty establishing the European Community, TEC).¹⁰ That article contains different steps that should ensure that budgetary deficits stay below three per cent of Gross Domestic Product (GDP). The Commission's first step may be to issue a so-called 'early warning' if a member state is likely to exceed the three per cent ceiling.¹¹ After many steps, the EDP could lead to a fine of a member state that

⁹ Council Regulation (EC) No 1466/97 of 7 July 1997 on the strengthening of the surveillance of budgetary positions and the surveillance and coordination of economic policies, *Official Journal L 209*, 02/08/1997 pp. 1-5; Council Regulation (EC) No 1467/97 of 7 July 1997 on speeding up and clarifying the implementation of the excessive deficit procedure, *Official Journal L 209*, 02/08/1997 pp. 6-11; Resolution of the European Council on the Stability and Growth Pact Amsterdam, 17 June 1997, *Official Journal C 236*, 02/08/1997 pp. 1-2.

¹⁰ On the origins of the Stability and Growth Pact and why it was deemed to be needed see Heipertz and Verdun (2004).

¹¹ Formally the Commission proposes a recommendation to the Council to address an early warning.

over a period of two years has still failed to correct the excessive deficit. Such fines are between 0.2 and 0.5 per cent of the member state's GDP, depending on the severity of the excessive deficit. The Council plays a key role in the enforcement of the SGP as it votes in each of the steps on a Commission proposals.

The SGP is an example of an incomplete contract as it is vague as to specifics in the application stage. To give an example, the wording of Article 104 paragraph 9 TEC reads:

'If a member state *persists in failing* to put into practice the recommendations of the Council, the Council *may decide to give notice* to the member state to take, within a specified time-limit, measures for the deficit reduction which is *judged necessary* by the Council in order to remedy the situation.' (Art 104 (9) TEC, emphasis added).

It is not exactly clear what the exact meaning is of, for example, 'may decide to give notice'. It thus took additional Council decisions to clarify how the treaty articles, the two regulations and the Council Resolution were to be applied. The regulation Council Regulation (EC) No 1467/97 of 7 July 1997 on speeding up and clarifying the implementation of the excessive deficit procedure stipulates in Article 5 when this should happen:

'Any Council decision to give notice to the participating member state concerned to take measures for the deficit reduction in accordance with Article 104c (9) shall be taken within one month of the Council decision establishing that no effective action has been taken in accordance with Article 104c (8)'.

The wording of the SGP was even so vague that opinions differed on its content. In first instance the SGP was seen by most as a system to enforce discipline by a symbolic, 'blaming and shaming' effect (see e.g. Heipertz and Verdun 2004). But by 2001 it became clear that the Commission was serious about the SGP and that it could actually have pecuniary effects.

The SGP is also an example of EU legislation that large member state did attempt to renegotiate and small member states did not. The first two countries to receive an early warning under the EDP were Germany and Portugal. Portugal, a small member state, responded strongly to the early warning and managed to reduce its deficit before entering the serious steps of the EDP procedure (Article 104 (9) TEC). In May 2004, the procedure was closed for Portugal. Germany, a large member state, reacted furiously to its early warning, but did not make the

necessary steps to reduce its deficit. The Commission nevertheless withdrew its early warning shortly thereafter. In January and June 2003 Germany and France and respectively entered the next steps of the EDP when the Commission proposed a recommendation on the basis of the Treaty Article 104 paragraph 7.¹² Rather than taking active steps to reduce their deficits France and Germany spent the month of October convincing other member states that the EDP would need to be suspended for these two countries. This indeed happened at the Ecofin Council meeting of 25 November 2003 (2546th Council Meeting Economic and Financial Affairs, Brussels 14492/03, Presse 320). A proposal of the Commission to take France and Germany to the next steps of the EDP was rejected and instead the Council adopted a decision to hold the SGP ‘in abeyance’ (temporarily abandon the SGP) for these two countries.¹³

The November 2003 Ecofin Council decision boiled down to a case of contract renegotiation. It had not been anticipated by the founding fathers of the SGP that the Council could decide to suspend the excessive deficit procedure set out in Article 104 TEC and further elaborated on in the SGP. Indeed, even the Commission put in the minutes that it regretted the decision by the Council and reserved the right to investigate subsequent actions.

After the November 2003 Ecofin Council meeting the Dutch government openly voiced the possibility of taking the governments of France and Germany to Court. In the end it was the Commission that challenged the controversial November 2003 Council decision in a case brought before the European Court of Justice (ECJ). The Dutch insistence to stick to the rules was striking, as it was clear that the Netherlands were going to breach the three per cent deficit rule and enter the EDP themselves.¹⁴

Our model explains the paradoxical move of the Dutch government. The Netherlands realized that, as a small member state, it has little leverage in the Council to bend the rules. Rather than attempting to renegotiate the EDP, it realized the importance of hardening the rules, i.e. making the contract more complete.

A hearing was held on 28 April 2004 in which the Commission questioned the legality of the Council decision. The Council pleaded that it had the right not to take over the Commission proposal (see the language in Article 104(9) cited

¹² The Council adopted the recommendation on 25 November 2003 for both France and Germany.

¹³ To be precise, a proposal for a Council recommendation based on Article 104 (7) was accepted (see above), but two proposals for Council recommendations based on Art 104 (8) and 104 (9) of the Treaty on European Union were not adopted. There were no provisions in the SGP that allowed the Council to hold the SGP in abeyance in these particular circumstances.

¹⁴ In December 2003 the Dutch statistical office (‘Statistics Netherlands’, or the ‘Centraal Bureau voor de Statistiek’) forecast a deficit above the three per cent ceiling.

above ‘... the Council may decide to give notice ...’). Nevertheless, although the ECJ agreed with the Council that it had the right to decide whether or not to adopt the Commission proposal, the ECJ ruled on 13 July 2004 that the Council decision had been illegal, as it did not have the right to rule that the EDP could be held in abeyance in the cases of Germany and France since this decision did not follow a proposal of the Commission.

6. CONCLUSION

This paper has analyzed the extent to which changes in EU governance affect strategic behaviour of individual member states in the Council. We have introduced a model that shows how the changes affect small and large member states. Our model shows that small member states will tend to back proposals for legislative acts that have few ambiguities and ones that describe extensively how the act is to be applied in the future (complete contracts). By contrast, large member states will favour proposals that contain ambiguous statements and will leave discretion to the Council for the aftermath (incomplete contracts).

We have also argued (Section 2) that we believe that the contrast between large and small members states has widened in recent years and thus will more often play a role in the present and the future than in the past. We offered two reasons for this change, namely, first, that the Treaty of Nice and ‘enlargement’ mean a further increase in the scope for qualified majority voting in the Council and, secondly, the increase in the relative voting power of individual large member states.

The paper has discussed the Stability and Growth Pact (SGP) as an example of our model. We have focused on how small and large member states have dealt with the aftermath of the SGP. Small member states in violation of the Excessive Deficit Procedure (EDP) (Portugal and the Netherlands) have accepted their fate and were willing to fight for the integrity of SGP. Large member states, for example, France and Germany, challenged the act so that it be applied less stringently to them than originally agreed to.

Our theoretical model assumes all other things equal. Thus we would only expect to find the model’s predictions to hold over the long run and when considering large numbers of cases of legislative acts that are binding on member states and that cover a broad variety of policy-making areas. In smaller samples many other factors might disturb the findings.

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ROTATION, REPRESENTATION OR RATHER A RAGGED REFORM? ON THE POLITICAL ECONOMY OF ECB RESTRUCTURING

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ABSTRACT

Most new member states of the European Union (EU) have achieved a high level of convergence to the euro area and strive for early introduction of the euro. Enlargement of the euro area requires a reform of current decision-making rules on monetary policy in the European Central Bank (ECB). In 2003 the European Council adopted a reform of the ECB Governing Council. The reform combines rotation and representation with regard to voting rights of governors of national central banks in the ECB Governing Council. However, it fails to cope with the most important issue, namely the ability of the ECB to keep average inflation in an enlarged euro area low. Based on a public choice approach, this paper asks why an ill-suited proposal was put forward by the Governing Council of the ECB and why this proposal was approved by the European Council. There are indications that the reform was primarily motivated by self-interest of the actors involved in decision-making.

INTRODUCTION

In May 2004 the number of member states in the European Union (EU) increased to twenty-five. Yet Economic and Monetary Union (EMU) has not been

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directly affected by EU enlargement. The euro area still only comprises twelve countries and new member states need to meet convergence criteria before being considered for eurozone membership. However, unlike Denmark, Sweden and the UK, elites in the new member states are quite keen on the introduction of the euro and eager to achieve this goal as soon as possible. Although most new member states do not yet meet the convergence criteria the euro area will be enlarged starting with Slovenia in 2007.²

Enlargement of the euro area will beget changes in the institutional setting of the Eurosystem as more central banks will participate in decision-making on monetary policy. As von Hagen and Süppel (1994), von Hagen (2000) and Hefeker (2003) have shown, the institutional design of decision-making in a federal central bank, such as the European System of Central Banks (ESCB), is a crucial determinant of the welfare effect of monetary policy. In order to cope with the challenges from potential enlargement, the European Council agreed to reform the voting procedure in the Governing Council of the ECB in March 2003.

This reform falls short of reform proposals proposed by academics in the scholarly literature. Based on efficiency claims many scholars favour more radical reform, delegating monetary policy to a decision-making body independent of member states (e.g. Baldwin et al. 2001; CEP 2002). At the same time Heisenberg (2003) emphasizes the need for increasing transparency in decision-making in order to make any reform towards denationalization viable. This paper addresses the question of why neither the European Council nor the ECB have supported these proposals but instead opted for a short-sighted and, partly, ill-suited option. In doing so the paper is inspired by the economic theory of democracy (Buchanan and Tullock 1962) and bureaucracy (Downs 1957; Niskanen 1971).

The first section of this paper develops a scenario of EMU enlargement based on convergence of EMU outsiders to the euro area, as well as on their preferences concerning the introduction of the euro. Section 2 discusses institutional implications of EMU enlargement with regard to decision-making on monetary policy and, in addition, it reviews alternative proposals for revision of ECB decision-making, as well as the respective reform put forward by the ECB and adopted by the European Council. Section 3 analyses the European Council's decision from a public choice perspective. The last section draws conclusions based on the findings of this paper.

² http://ec.europa.eu/economy_finance/euro/transition/future_enlargement.htm

1. ENLARGEMENT OF THE EURO AREA: A SCENARIO

Since the most recent enlargement of the EU in 2004 the number of EU members retaining a national currency exceeds the number of members joined together in the euro area. However, this situation is likely to be merely transitory. The ten new EU members and Sweden formally hold the position of member states with derogation, until they fulfil the convergence criteria for the introduction of the euro. As the Swedish example demonstrates a country can voluntarily default on the criteria. Only Denmark and the UK are exempted from participation in the third stage of EMU. Nevertheless, the door to the euro is open for them as well. As long as a country meets the convergence criteria and has the political will to join the euro area any EU member state can apply for euro membership and if approved can move on to introduce the euro.

Convergence is measured on the basis of criteria given in Article 121 of the Treaty Establishing the European Community (TEC) and is further specified in an additional protocol to that Treaty. They can be summarized as follows.

- *Inflation*, based on the consumer price index (CPI), must not exceed, in the year before the examination, the level of the three best-performing member states in terms of price stability by more than 1½ percentage points.
- The *long term interest-rate*, measured on the basis of long term government bonds, must not exceed, in the year before the examination, the level of the three best-performing member states in terms of price stability by more than 2 percentage points.
- The *exchange rate* vis-à-vis the euro must be stable 2 years before the examination, i.e. it must be close to the central rate specified in an exchange rate mechanism (ERM) II agreement without severe tensions, in particular devaluations.
- As for *public finance* at the time of examination the member state must not be subject of a Council decision specifying that an excessive deficit exists. This implies:
 - ⇒ the planned or actual deficit must not be higher than 3 per cent of Gross Domestic Product (GDP)
 - ⇒ the level of public debt must not exceed 60 per cent of GDP.

However, it is subject to interpretation by the Council whether a level of deficit or of debt exceeding the respective threshold constitutes an excessive deficit.

- *Legal convergence*, in particular with regard to the independence of the central bank, must be achieved.

Table 1 provides information on convergence achieved in 2004 with regard to the criteria on inflation, the interest rate and on public finances. As the figures show, notable convergence has already been achieved in a number of new member states, most notably the Baltic states, Slovenia and the Czech Republic. Problems may arise concerning inflation depending, among other things, on the strength of the Balassa Samuelson effect. In addition the public deficit in some countries presents cause for concern. In particular Poland, Malta and Hungary have adopted measures that may be merely cosmetic and may be insufficient to correct a structural imbalance in public finances.

Table 1. Nominal convergence of EMU outsiders (2004).

Country	CPI	Interest rate	Budget deficit / GDP	Public debt / GDP
Cyprus	1.9	6.08	-4.2	71.9
Czech Republic	2.6	---	-3.0	37.4
Denmark	0.9	4.30	2.8	42.7
Estonia	3.0	---	1.8	4.9
Hungary	6.8	8.19	-4.5	57.6
Latvia	6.2	4.85	-0.8	14.4
Lithuania	1.1	4.43	-2.5	19.7
Malta	2.7	4.68	-5.2	75.0
Poland	3.6	6.92	-4.8	43.6
Slovakia	7.4	5.02	-3.3	43.6
Slovenia	3.6	---	-1.9	29.4
Sweden	1.0	4.42	1.4	51.2
UK	1.3	4.93	-3.2	41.6
Reference value*	2.2	6.28	3.0	60.0

* The calculation of the reference value of inflation and of the interest rate is based on the respective figures of Denmark, Finland and Sweden since these countries performed best in 2004 with regard to CPI.

Source: Eurostat; own calculations.

For an assessment of the date of enlargement of the euro area the exchange-rate criterion is important due to the circumstance of the 2-years-period of observation formally not being able to start before an ERM II agreement has come into force. The ERM II is a bilateral system of fixed, but adjustable, exchange rates between the euro and the national currency of an EU member state. As can be seen from table 2 Denmark, Estonia, Lithuania and Slovenia already signed ERM II agreements in mid 2004. One year later Cyprus, Latvia and Malta followed. Denmark aside, this seems to be in line with the ambitions of these countries to introduce the euro as soon as possible. However, those new member states which have not yet signed an ERM II agreement are striving to switch to the euro by 2010 as well.

Table 2. Exchange rate systems in EMU outsiders and envisaged introduction of the euro (2005).

Country	Exchange rate system	ERM II agreement	Introduction of the euro envisaged for
Cyprus	Euro peg	Since 02/05/2005	2007
Czech Republic	Managed floating	No	2009
Denmark	Euro peg, +/- 2,25%	Since 27/06/2004	Open
Estonia	Euro currency board	Since 27/06/2004	2006
Hungary	Euro peg, +/- 15%	No	2010
Latvia	Euro currency board	Since 02/05/2005	2008
Lithuania	Euro peg, +/- 15%	Since 27/06/2004	2007
Malta	Euro peg	Since 02/05/2005	2008
Poland	Free floating	No	2009
Sweden	Managed floating	No	Not before 2012
Slovakia	Managed floating	No	2009
Slovenia	Euro peg, +/- 15%	Since 27/06/2004	2007
UK	Free floating	No	Open

Source: Information from national central banks.

Based on the level of convergence and on the will of political elites in the new member states one should reasonably expect enlargement of the euro area by five new members in 2007 or 2008. From 2010 membership in the euro area is likely to be close to, or even in excess of, twenty countries. Can the institutional setting of the Eurosystem accommodate this many countries?

2. DECISION-MAKING IN THE ECB AND EMU ENLARGEMENT

As is a well-known fact regarding EU enlargement, increasing the number of member states may require a revision of the institutional setting. For instance, the European Council of Nice agreed to a modification of the composition of the European Commission and to a new allocation of votes in the Council of Ministers. This section discusses the need for institutional adaptation of the ECB stemming from enlargement, starting with a description of the composition of the ECB Governing Council, the most important decision-making body for monetary policy, and voting rules therein. Challenges arising from enlargement will be identified and reform options will be discussed. The end of this section gives a sketch of the reform proposed by the ECB and adopted by the Council of Ministers of Economic and Financial Affairs and points out its shortcomings.

2.1. Current Rules and Enlargement

For reasons beyond the scope of this paper the signatories of the Maastricht Treaty favoured that the monetary constitution for the European System of Central Banks (ESCB) closely follows the Law relating to the Deutsche Bundesbank (for a discussion see Verdun 2000). With the Bundesbank's constitution reflecting the federal structure of the German state the ESCB must also be labelled a federal central bank. The federal element is most visible in the composition of the Governing Council of the ECB.

The Governing Council comprises the Executive Board of the ECB and the governors of the national central banks (NCBs) of the Eurosystem. Currently eighteen seats in the Governing Council are shared among six representatives taken from the ECB and twelve governors from the NCBs. The Governing Council decides on monetary policy matters by simple majority vote, whereas the principle 'one person, one vote' applies to all its members. Given this setting, enlargement of the euro area directly affects the composition of the Governing Council because the governor of a new member's NCB obtains a seat and the right to vote. As a corollary, enlarging the euro area has two effects. First, the total number of members in the Governing Council increases. Second, the share of NCB representatives in the Governing Council increases as the number of representatives of the ECB remains unchanged.

Two problems may arise, potentially hindering the ECB in achieving its main task efficiently, namely to keep inflation in the euro area low. First, a larger number of members in the General Council may impede flexibility in decision-making. The variety of perspectives on monetary policy will broaden, in particular when preferences are heterogeneous. Heterogeneity may be due to unsynchronized business cycles, Balassa-Samuelson-inflation in the catch-up process, different preferences on inflation, different structures of the financial systems and asymmetric demand shocks. Although there exists no unambiguous empirical evidence one can nevertheless reasonably assume that real economic convergence will take longer than nominal convergence measured by the Maastricht criteria. Hence, different national preferences and time-consuming discussions can reduce the ability of the Governing Council to take decisions on monetary policy flexibly and smoothly. Postponing a decision, e.g. to increase interest rates in order to fight inflation, may require more radical and costly measures later.

Second, overrepresentation of NCBs in the General Council can lead to sub-optimal decisions. The ECB conducts a single monetary policy for the entire euro area with the aim to keep average inflation low and stable. It is reasonable to assume that members of the Executive Board of the ECB cast their votes in the Governing Council on the basis of average figures for the euro area. However, this choice might not always be favoured by representatives of NCBs. At any time there are inflation differentials between the individual member states. A booming country, e.g. Ireland, facing inflationary pressures, may wish to tighten monetary policy, whereas at the same time a poorly performing economy, such as Germany or Italy, challenged by rising unemployment and not experiencing upward pressure on prices, would prefer a more relaxed policy stance. Although formally independent and committed to policy for the entire euro area, NCB governors may well perceive economic problems differently and may thus vote according to national, rather than average, figures. This concern is supported by evidence from the US Federal Reserve Bank which shows that the voting behaviour of representatives from District Banks can be better explained by economic circumstances in their respective districts than by average figures for the US economy (e.g. Meade and Sheets 2002). Following this line of reasoning voting based on national preferences may become more important with enlargement as the relative power of the ECB representatives in the Governing Council deteriorates. This situation could result in sub-optimal decisions, in particular when a large number of representatives from small countries vote systematically differently than representatives from large countries. Both the numeric problem

and the problem of overrepresentation of NCBs pose serious challenges for monetary policy in the euro area. These challenges require institutional reforms.

2.2. Options for Reform

Three groups of reform options have been discussed: rotation, representation, and delegation (see De Haan, Eijffinger and Waller 2005: ch. 7 for a discussion of pros and cons of the options). According to the model of *rotation* the number of votes in the General Council is smaller than its number of members and voting rights rotate between the representatives of the NCBs. The frequency of rotation does not have to be the same for all members; it can vary depending on GDP or the population size of a country. This model has been practiced by the US Federal Reserve Bank since 1935 (see Berger, de Haan and Inklaar 2002: 21, and onwards, for a discussion of different rotation schemes).

Following the principle of *representation* the vote of a member in the Governing Council represents a group of countries. Grouping of countries can follow different criteria, such as similar economic size of individual groups or geographic proximity or similar business cycles of countries within a group. For example, representation is applied in the allocation of voting rights in the International Monetary Fund (IMF).

Delegation of monetary policy to a decision-making body which is more independent from member states is much preferred from an efficiency point of view (Baldwin et al. 2001). This can be achieved either by setting up a new council of monetary experts in charge of monetary policy or by a new division of labour between the bodies of the ECB assigning the Executive Board with sole responsibility over for monetary policy. In practice many central banks have implemented a weak form of delegation.

In March 2003 the European Council adopted a reform of the ECB Governing Council which still needs to be ratified by the member states according to their national constitutional provisions. The Council decision will not change the composition of the Governing Council but the number of votes allocated to representatives of NCBs will be limited to fifteen. In order to implement this cap on votes a mechanism combining the principles of rotation and representation will come into effect once the number of members in the euro area exceeds fifteen. The Governing Council of the ECB may unanimously postpone implementation of the mechanism until more than eighteen countries have joined the euro area.

For the euro area comprising fifteen to twenty-one members there will be two groups of countries. Grouping will be based on a composed indicator with the

weights for a country's GDP of 5/6 and the total assets of the aggregated balance sheet of its monetary financial institutions of 1/6 respectively. The five countries ranking highest with respect to this indicator will be in the first group to which four votes will be allocated. The remaining eleven votes will be allocated to the second group comprising the rest of the members of the euro area.

Once there are twenty-two or more members of the euro area, countries will be split into three groups. Again, the first group having four votes is made up of the five largest countries according to the composed indicator. The second group comprises half the number of total members in the euro area following the five largest with regard to the composed indicator. They will receive eight votes. The rest of the countries are subsumed in the third group with three votes.

In order to illustrate the consequences of this reform table 3 exemplifies the allocation of voting rights in the Governing Council for two different scenarios. The first one refers to enlargement of the euro area by the five new countries which are most advanced in respect to the Maastricht criteria. The second scenario holds that all new EU member states are members of the Eurosystem. Assuming equal treatment of all members within the same group, scenario 1 implies that Germany, France, Italy, Spain and the Netherlands would each be members without a vote in one out of five periods. The rest of the countries of the euro area would be even better off than the five largest ones because each of them would only be without a vote once in twelve periods. Scenario 2 does not affect the first group. However, members in the second group would lose their voting right for three out of eleven periods, whereas countries in the third group would on average not vote every other period. Note that, in addition to the scenarios, the decision of the UK to switch to the euro would relegate the Netherlands to the second group.

Table 3. Examples of the composition of the allocation of voting rights in the enlarged Eurosystem.

Scenario 1: EMU(12) + Estonia, Lithuania, Latvia, Malta, Slovenia		Scenario 2: EMU(12) + 10 new member states	
Group 1: 4 votes	Germany, France, Italy, Spain, The Netherlands	Group 1: 4 votes	Germany, France, Italy, Spain, The Netherlands
Group 2: 11 votes	Belgium, Austria, Ireland, Portugal, Greece, Luxembourg, Finland, Slovenia, Lithuania, Latvia, Estonia, Malta	Group 2: 8 votes	Belgium, Austria, Ireland, Poland, Portugal, Greece, Luxembourg, Finland, Czech Republic, Hungary, Slovakia
		Group 3: 3 votes	Slovenia, Lithuania, Cyprus, Latvia, Estonia, Malta

This reform has been criticized widely. Apart from little transparency and elements of arbitrariness, e.g. the relative weights of GDP and the size of the financial services sector in the composed indicator, a major shortcoming of the new provisions is their inability to solve the two problems enlargement is likely to bring about. Efficiency of decision-making and flexibility of monetary policy will not improve because the governors of NCBs from all EMU members will participate in the meetings of the Governing Council not only as observers but they will have unrestricted right to speak. It is reasonable to assume that countries without the right to vote will contribute to discussions in the Governing Council even more, since it is their only possibility to influence the voting outcome. Effectiveness, understood as the likelihood for the 'optimal' decision based on aggregate figures for the euro area rather than regional figures, will increase in comparison to enlargement without any reform. However, a comparison to other federal central banks suggests that the ECB continues to be too decentralized.

Table 4. Composition of the monetary council in federal central banks.

Central bank	Members from the central unit	Members from regional units	Council members	Central / total
Bank Deutscher Länder until 1957	1	9	10	0.10
Deutsche Bundesbank until June 1992	max 10	11	max 21	≤ 0.48
Deutsche Bundesbank from July 1992	max 8	9	max 17	≤ 0.47
US-Fed until 1935	7	8 – 12	15 – 19	0.37 – 0.47
US-Fed from 1935	7	5	12	0.58
ECB (12)	6	12	18	0.33
ECB (≥ 15)*	6	15	21	0.29
ECB (≥ 15)**	6	15 – 18	21 – 24	0.25 – 0.29

* This row assumes that the new provisions for the Governing Council become effective once membership exceeds 15.

** This row assumes that the Governing Council makes use of the option to postpone the application of the new provision until membership exceeds 18.

The last column of table 4 can be interpreted as a measure of centralization of monetary policy. The higher the share of representatives from 'the centre' the more centralized is monetary policy. In the US since 1935, for example, the representatives from the Washington-based Federal Reserve Bank do not need additional votes from governors of district banks in order to take a decision. Likewise the reforms of the Deutsche Bundesbank in 1992, following German

reunification, aimed at preserving the relative power of the centre. On the contrary, the reform of the ECB does not prevent the power of the Executive Board in the Governing Council, relatively weak in international comparison, from further deterioration. The puzzle remains as to why such an ill-suited reform has been adopted and will be most likely ratified.

3. UNDERSTANDING THE REVISION OF THE DECISION-MAKING RULES

There are a number of different approaches to study and understand the change of institutions. They can be grouped into three schools of thought: historical institutionalism, sociological institutionalism, and rational choice institutionalism (e.g. Hall and Taylor 1996).

Historical institutionalism highlights the role of institutions for structuring relations between actors and groups in society who, more often than not, have conflicting interests regarding the allocation or distribution of resources. Institutions persist if they provide for an outcome of the interaction between the respective actors which is superior to likely outcomes under alternative institutional settings. On the contrary, institutions change if alternative formal rules credibly promise a superior outcome. Pierson and Skocpol (2002) list three characterising features of studies in the tradition of historical institutionalism: the focus on 'big issues' of social importance, such as failure or success of economic and political regimes, democratization, or distributive policies affecting large groups in society; the analysis of historical processes thereby emphasising path dependence, the importance of timing and sequencing and critical junctures; and the contextualization of institutions, i.e. the interference of different sets of institutions and their social and political embedding.

The voting rules in the Governing Council of the ECB do not pose a major social problem. Their current reform does not have any clear-cut foreseeable consequences for the distribution of income or wealth. The risk of 'sub-optimal' decisions refers to too restrictive a monetary policy just as much as to an overly expansionary one. Likewise, winners or losers on the level of EMU member states are not clearly identifiable because the frequency of having a vote depends on group membership, the number of groups, and the number of other members of the same group. All this is subject to change over time. Moreover, tracing the historical development of monetary or economic policies in the euro area is not very helpful for dealing with our problem, not the least because EMU is still a

relatively young project. This is not to say that EU enlargement must not be considered being a critical juncture or that the decision at Maastricht for an independent, federal central bank in EMU did not limit the set of feasible reform options. However, these variables cannot explain why an ill-suited voting rule will soon be in place.

From the perspective of sociological institutionalism, institutions are practices firmly embedded in their cultural environment. Both culture and institutional practices mutually influence each other. Persistence of a particular institutional setting is largely due to cultural stability whereby institutional change can be triggered by cultural dynamics. However, mutual interdependence means that this may also work the other way round. EMU and the common currency with all its symbolism, for instance, can be interpreted as an institution designed to reinforce European rather than national identity in the EU (Risse, Engelmann-Martin, Knope, and Roscher 1999).

Applying a sociological institutional approach to the issue at hand would mean over-exaggerating the identity-creating importance of ECB voting rules of which people are generally not aware. There is hardly any symbolism involved. Sociological institutionalism may at best explain why reform options with a wider social impact have not been accepted. The model of delegation, for instance, implied that monetary policy decisions were to be taken by Eurocrats with no involvement of national representatives. However, sociological institutionalism cannot provide a reasonable explanation for the adoption of the current reform.

Rational choice institutionalism (see Shepsle 2006) views institutions as rules of human interaction chosen by decisive, i.e. powerful, actors to serve their own ends. This school of thought is based on methodological individualism. Actors are assumed to act solely in their own interest. The preferences of individual actors are exogenous. Hence, institutional change occurs if, *ceteris paribus*, an alternative institutional setting is more beneficial for a group of decisive actors.

In the public sphere two types of actors need to be distinguished: politicians and bureaucrats. Politicians are in power because they achieved a majority of votes in the last election (see Buchanan and Tullock 1962). They act under the re-election constraint, implying that their incentive is to maximize votes in the next elections. In a pluralistic society they need to set policies in line with the preferences of the median voter. In a corporatist society this means to design policies in accordance with the preferences of those interest groups which deliver the highest expected number of votes from their respective constituents.

Bureaucrats are not elected by the people. They are in office because they have been appointed by policymakers who delegate specific tasks to them. Aiming for prestige and influence, a bureaucrat frequently strives for the

maximization of the office budget which allows, among other things, for an increase in the number of staff and bureaucratic output. A bureaucrat faces the constraint of re-appointment (see Downs 1957; Niskanen 1971).

In order to make use of rational choice institutionalism for the interpretation of the ECB reform, the actors involved and the extent of their formal powers first need to be identified. The European Council of Nice added Article 10.6 to the Statute of the ESCB and the ECB which stipulates the formal decision-making procedure for a revision of voting rules in the Governing Council as laid down in Article 10.2 of the Statutes. Accordingly, a unanimous decision of the European Council can amend the voting rules on a proposal by the Governing Council or by the European Commission. If the Governing Council issues a proposal, the Commission and the European Parliament (EP) should provide their opinion on it. If the proposal is from the Commission it is up to the Governing Council and the EP to give their opinions. Hence, both the Governing Council and the Commission are vested with potential agenda-setting power whereas decision-making power lies with the European Council. The EP is merely a consultative body. The remainder of this section analyzes the position of each of these bodies and tries to explain this position on the basis of public choice theory.

3.1. The Governing Council of the ECB

Members of the Governing Council are bureaucrats in the sense of the public choice theory. Members of the Executive Board of the ECB are appointed by the European Council for a term of seven years. NCB governors are appointed in accordance with the national legal requirements of the respective country. Putting forward a reform proposal required unanimous agreement within the Governing Council.

Being both potential agenda-setter and subject to any decision on voting rights at the same time, all members of the Governing Council naturally had a strong interest in the issue. Thus it is little surprise that the General Council tabled its recommendation for a revision of voting rights on 3 February 2003, the first working-day after the Treaty of Nice went into force. Postponing the proposal entailed the risk for the Governing Council of losing the first mover advantage to the Commission.

In order to understand the nature of the proposal two groups of members in the Governing Council have to be distinguished: the Executive Board of the ECB and governors from the NCBs. Of course ECB Board members were in favour of any reform which increased their competence over monetary policy and their

power in the Governing Council respectively. However, Article 10.6 enables merely reforms which address voting in the Council. The composition of the Council itself or the division of labour between the Governing Council and the Executive Board must not directly be affected. This ruled any form of delegation out, which the Executive Board had certainly preferred most. An increase of power within the Governing Council was still a preferred, but unrealistic, option given that this would have required a drastic cap on voting rights for NCB governors. Thus, the representatives from the ECB were in an unfavourable position and their aim had to be to keep the loss of power within the Governing Council to a minimum.

Representatives from NCBs considered foremost their individual career perspectives when drafting the reform. From this point of view, only those reform proposals which would make sure that no incumbent NCB governor would ever become a member of the Governing Council without a voting right had the chance to be unanimously adopted. Table 5 provides information on the career perspectives of all NCB governors who agreed to the reform proposal in December 2002. The estimation of the maximum stay in office takes into account national legal provisions such as a limitation of re-appointments or a maximum age of a governor. In addition it is based on the assumption that any NCB governor retires at the age of 70, at the latest.

Table 5. Terms of central bank governors in the Euroarea (2002).

Bank	Governor	Max. stay
Austria	Klaus Liebscher	2009
Belgium	Guy Quaden	2009
Finland	Matti Vanhala	2012*
France	Jean-Claude Trichet	2005
Germany	Ernst Welteke	2007
Greece	Nikolaos Garganas	2008
Ireland	John Hurley	2009
Italy	Antonio Fazio	2006
Luxembourg	Yves Mersch	2008
The Netherlands	Nout Welling	2011
Portugal	Vítor Manuel Ribeiro Constâncio	2012
Spain	Jaime Caruana	2006

* At the end of 2002 Matti Vanhala probably already knew that he would not keep his position until 2012 due to serious health problems. He stepped down from being governor in early 2003 and passed away shortly thereafter.

Source: National central banks on inquiry.

More than half of the position holders knew in December 2002 that they would not be in office anymore when the first of the new member states introduced the euro. However, enlargement involved some uncertainty for the remaining NCB governors whose term would run longer than 2008. The best alternative to cope with this uncertainty was to set the threshold of membership, from which the reform becomes effective, as high as possible and to formulate the exact terms vaguely enough as to make them subject to later re-interpretation.

As demonstrated above a threshold of fifteen members is relatively high when compared internationally. In addition, the proposal put forward by the Governing Council entails numerous obscuring clauses and leaves other issues open to later decisions. First, the Governing Council can unanimously lift the threshold to eighteen members and will most likely do so. Second, rotation within the groups has not yet been specified at all. The duration of a period during which a governor can exert a voting right still needs clarification and so does the order of countries to exert voting rights.

3.2. The European Commission

In 2003 the European Commission was made up of twenty Commissioners. Although proposed by the government of a member state and appointed by the European Council, a Commissioner is formally independent and remains in office for a renewable term of five years. Thus, the Commission is a bureaucracy *par excellence*, according to the economic theory of bureaucracy. The *collegium* of Commissioners decides with the simple majority of its members.

At first glance the decision of the Commission not to make use of its agenda-setting power may be surprising (see e.g. Baldwin et al. 2001 who expected the Commission to table a proposal). However, doing so would have implied an open contest with the ECB. Given the sensitivity of the issue for the Governing Council and comparably small stakes a Commissioner has in ECB voting rules, the Commission apparently forbore from a proposal. In addition, due to the nature and the self-perception of the Commission itself, a Commissioner generally has sympathy for the idea of an independent bureaucracy on the supranational level. There may well be tacit agreement between the Commission and the ECB to refrain from activity which challenges each other's independence. Nevertheless the Commission commented critically on the ECB's proposal (European Commission 2003). The comments basically address three issues.

- *Criticism of the ECB's proposal:* With regard to efficiency, the Commission proposes to reduce the number of voting rights below the one proposed by the Governing Council. In addition to GDP an indicator for ranking member states of the euro area should take into account the population rather than the size of the financial services sector. Moreover, the Commission asks for clarification of individual provisions, such as rotation frequency and allocation of voting rights within the groups and the effective start of the rotation system.
- *Reform of ECB governance in the long run:* Without being precise the Commission proposes the introduction of a monetary policy board which is not comprised of representatives of all EMU members, a new assignment of tasks to the ECB's Executive Board and a revision of the rules for the appointment of board members.
- *Spill-over to other EU institutions:* The Commission insists on the model for ECB reform not being a blueprint for the reform of any other institution of the EU.

Given that the Commission is doomed to have little, if any influence, on monetary policy in the euro area regardless of the institutional setting of ECB decision-making her position has to be read in a more general way. Doing so reveals a rather defensive position in two ways. First, the Commission wanted to indicate that its domain of power in the EU, namely the monopoly over the proposal of legislation, was not challenged by the fact that it granted the first move to the ECB. One possible way to do so was to criticize the proposal and to point to the need for further reform in the long run. Second, the Commissioners were particularly keen on ring-fencing the institutional setting of the Commission, which exhibits some similarities to the Governing Council of the ECB when it comes to the voting procedures.

3.3. The European Council

The Council is an intergovernmental body in which representatives of the member states convene either in the composition of Heads of State or Government (European Council) or in the composition of ministers in charge for a specific subject (Council of Ministers). Thus, the behaviour of an individual Council member is described by the economic theory of democracy.

With regard to the position of the Council two questions are interesting: Why did the Council rule out far-reaching reforms from the very beginning by phrasing

the enabling clause (Article 10.6) accordingly? Why did the Council ultimately approve the proposed recommendation by the ECB?

The members of the European Council were not keen on a radical reform as they were trapped in the federal design of the ESCB set out in the Maastricht Treaty. The federal set-up accounts for the governments of any member state of the euro area having a vital interest in ECB decision-making. Once federal elements have been established, path dependence makes radical reforms hard and extremely unlikely. As mentioned above there is good reason to assume that NCB governors cast their votes in the Governing Council on the basis of the economic situation in their home countries. In other words, whenever the assessment of the national economic situation of the government is in line with the one of the NCB governor it is beneficial for the government to have a national representative in the Governing Council.

The fact that the European Council approved the ECB's proposal can be explained by relatively high costs and few potential benefits of not doing so. Costs were rather indirect because interfering into the position of the ECB could have been interpreted as challenging its independence. It is widely accepted nowadays that independence of a central bank is crucial element to secure low and stable inflation. Central bank independence has become a holy cow. Nevertheless, the members of the European Council certainly would not have refrained from challenging it if there had been high potential vote gains from it. ECB voting rights, however, do not figure high in voters' preferences. Hardly anyone is aware of decision-making procedures and outcomes in the ECB. Even the banking industry appears not to have much interest in it, as one can conclude from the fact that no national or European banking association issued a single position paper or any other public statement on the reform.

3.4. The European Parliament

Like representatives in the Council of Ministers the members of the European Parliament need support of voters in the next election. However, the problem of the EP is not only that voting in the ECB is not a very popular issue among voters but, even more severely, that only a minority of voters acknowledge the activities of the EP at all, as poor turnout in EP elections suggests. Thus, the prime motivation of the EP is generally to be taken into account by voters, which would enable the EP to claim more influence in EU policy-making (see also Vaubel 1994). A potential strategy to do so is to take on an extreme position.

In its opinion on the ECB proposal the EP followed this strategy by rejecting the proposal and reaffirming the existing composition and voting rules for the Governing Council (European Parliament 2003). In the constructive part of its opinion the EP favoured the model of delegation suggesting to enlarge the Executive Board to nine members and to strengthen its power over monetary policy. Furthermore the Governing Council should decide by double-majority based on more democratic principles.

This element of denationalization again reflects the broader preferences of members of the EP. The EP tends to opt for a more 'European', i.e. denationalized, and more democratic solution to almost any issue because this appears the most promising way to legitimately claim more powers.

4. CONCLUSION

The euro area will experience enlargement in 2007 when Slovenia joins. Other small new member states, such as the Baltic Republics, are particularly keen on replacing their national currencies with the euro before long and are at the same time the most advanced in terms of convergence with other euro area countries. Anticipating enlargement the European Council of Nice asked the ECB and the Commission for a proposal to adapt voting procedures in the Governing Council of the ECB. In particular two issues related to the current principle of 'one person, one vote' are to be solved when it comes to enlargement: a decrease in flexibility due to an increasing number of members in the Governing Council and the risk of sub-optimal decisions on monetary policy for the euro area due to overrepresentation of national interests.

However, the reform proposed by the ECB and adopted by the Council combining representation and rotation fails to address these problems effectively. The reform has been enacted anyhow, as it serves the interests of actors involved in decision-making best. The European Council limited the range of possible reforms in first place significantly in order to preserve the federal structure of the ECB. The ECB did not propose a more radical reform because alternatives within the remaining set of reforms contradicted individual career plans of members in the Governing Council. Although the criticism put forward by the EP and the Commission closely reflects comments by academic scholars, these actors are driven by self-interest in centralization and bureaucratic independence respectively. In the long run further reforms will be inevitable.

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PROGRESSING TOWARDS LEGITIMACY: FINANCIAL SERVICES SECTOR POLICYMAKING IN THE EU AFTER LAMFALUSSY

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ABSTRACT

The European Union (EU) is often perceived as lacking legitimacy. Yet, this understanding of EU policymaking is more and more contested through discussion of input and output legitimacy. The paper speaks to this issue by focusing specifically on integration in the financial services sector, particularly the securities industry, and by assessing how the policy process facilitates or impedes the legitimacy of policymaking in this field. By analyzing the Lamfalussy regulatory process, we argue that the EU has made important strides in ensuring both output and input legitimacy although there remain gaps in its approach. The legislative agenda of the Financial Services Action Plan was adopted on time and the regulatory process favours consultation with market actors. However, complete implementation of measures across the Union remains a problem as is the inability of end-users and consumers to fully access the policy process.

INTRODUCTION

The European Union (EU) is often assumed to lack legitimacy. The structure of the European Central Bank is often pinpointed as an important part of the

problem. Yet, recent scholarly work suggests the opposite – the European Union, when fairly compared with the practices of states, is actually largely democratically legitimate (Moravcsik 2004; Schmidt 2004). One of the useful distinctions that have been made to address these questions is between output and input legitimacy (Scharpf 1999). The former relates to government *for* the people and focuses on the results of governmental action. The latter refers to government *by* the people and speaks to the openness of the policy process. Arguably, both output and input legitimacy are necessary to ensure democracy. In the EU, it is clear that the European level is more and more intrusive in almost all areas of public policy. The EU has made real progress in furthering integration especially in regards to the economy (output legitimacy), but has been less successful in responding to citizen's welfare concerns. EU institutions also appear to make increasing attempt to consult and include all relevant actors in the policymaking process (input legitimacy), yet there are many challenges for private and social actors when it comes to having voice and influence in Brussels.

A useful way by which to determine if the EU is democratic, accountable and legitimate is to study its actions in specific policy fields. The paper undertakes this process of appraisal by focusing on policymaking in the financial services sector. This sector is apt for analysis for at least two reasons. First, it is generally agreed that in order for the EU to benefit fully from the creation of the euro and to facilitate the integration of the continent's economies as a whole, it needs to have a fully integrated financial services sector marketplace. As such, the integration of financial markets has become a priority for EU decision-makers who see it as essential in furthering economic developments. Second, the financial services policy field is a good test case because policymaking in this sector at the state level also poses inherent issues of democracy and legitimacy. The field is technical in nature and the policy network is usually composed of large, often influential, private corporate sector actors rendering it difficult for non-experts and citizens more generally to participate in the policy process. If the EU can be shown to have a certain level of legitimacy in this field, then it can be said to be more legitimate than often assumed.

How does the policy process facilitate or impede the legitimacy of policymaking in the financial services sector? By focusing on the Lamfalussy regulatory process,¹ we argue that the EU has made important strides in ensuring the legitimacy of policies for finance industries, acknowledging that there remain some gaps in its approach. Financial services sector policymaking, especially in

¹ The Lamfalussy process is a four-stage policymaking process that the EU implemented in 2001 to increase the speed and effectiveness of their policy (outlined in the Financial Services Action Plan [FSAP]) in the securities sector.

the securities industry which is the core focus of our analysis, has partly achieved output and input legitimacy. More remains to be done, however, for the people of Europe to benefit from the integration process and for them to have real input in the way policies in this field are elaborated.

The paper is divided in three parts. First, the concept of legitimacy is further discussed. Second, the policy process in the financial services sector is duly analyzed, after we provide a short summary of integration in this sector. Particular attention is paid to the consultation practices used in policymaking. Finally, we will return to discussing what this shift in the policymaking process has meant for the legitimacy of the policy sector.

1. INPUT AND OUTPUT LEGITIMACY

Questions about the legitimacy of EU policy processes and outputs are not new. As more policymaking authority has been transferred up to this level, these questions have only grown. While the EU has historically developed in a piecemeal fashion, it would now appear that the Union must focus on minimizing its democratic deficit and enhancing its legitimacy with EU citizens. One potential source of EU policy legitimacy emerges from the belief that there is some indirect legitimacy conferred through its composition of democratically legitimate actors. As interstate bargaining is at the basis of at least broad level European governance, it is essential that the national governments involved in the arena be democratically accountable to their constituencies (and parliaments) (Horeth 1999: 251). However, the potential of indirect legitimacy has been challenged. On a philosophical level, Majone (1999) argues that democratic institutions cannot transfer their legitimacy to non-majoritarian ones even though they may transfer policymaking responsibility. Others argue that there are indications that some of the practices which emerge in this relationship actually negatively impact legitimacy, including the practices of blame shifting, displacing national legitimacy problems to the European level without the appropriate shift in resources and the 'cartelization' of the relationship between state and Union by the bureaucratic elites (Lord and Beetham 2001: 444). Therefore, EU bodies must pursue strategies to ensure their own legitimacy. Lord and Beetham (2001) go so far as to argue that the EU cannot be seen as legitimate unless it directly develops the three dimensions of legitimacy: performance, democracy and identity.

One way to conceptualize the direct legitimation strategies that the EU undertakes is to look at the importance placed on input and output legitimacy. The three dimensions of legitimacy just mentioned map with input and output

legitimacy in that the first is output legitimacy and the second and third are more measures of input legitimacy. In general, claims of legitimate policymaking in the EU are often inherently – whether acknowledged or implicit – based on notions of output legitimacy. Output legitimacy involves focusing on the legitimacy of policy based on whether the outcome is *for* the people. Horeth states ‘The underlying assumption here is that the legitimacy of a political system depends on its capacity to achieve the citizens’ goals and solve their problems’ (1999: 251).

Although output legitimacy has traditionally been seen as sufficient, there has been a growing recognition of its inadequacy (Majone 2000; Skogstad 2003). As this has occurred more attention has been paid to the potential for input legitimacy of EU policymaking. At its core input legitimation relies ‘on the rhetoric of ‘participation’ and of “consensus”’ (Scharpf 1999: 7). Unlike output legitimacy’s focus on policy outcomes, the focus here is on the policy process – or government *by* the people. The importance of determining who is included in ‘the people’ has led some, particularly Scharpf (1999), to conclude that the EU cannot achieve input legitimacy in its current form because it lacks a thick European collective identity or *demos*. Although a ‘*demos*’ is not necessarily an ‘*ethnos*’, its members must still recognize each other as members of the same political community in order to acceptably use the majority principle of democracy (Horeth 1999). In essence, in order to achieve government *by the people*, it is argued that one needs to identify who the self-recognized ‘people’ are, something more easily done at the state than at a supra-national level.

Acknowledging that the lack of European identity is important, in this paper we sidestep the matter by taking a broader understanding of what can be included in input oriented legitimacy. Conventionally, utilization of this concept has been focused on the legitimacy achieved through traditional democratic institutions like elections or even direct forms of democratic decision-making of citizens (Michalowitz 2004). However, drawing from Skogstad (2003), we understand input legitimacy to include all strategies that the European bodies undertake to democratize the procedures which create policies. In this understanding the assessment of appropriateness under input legitimation is the ‘conformity of decision-making procedures with democratic norms of public participation and control’ as distinguished from output legitimation strategies which rely instead on the perceived merit of policy outputs as the measure of appropriateness (Skogstad 2003: 324-5).

There are a number of different but overlapping legitimating strategies that the EU can take to enhance its claims of input legitimacy. Some of these strategies include: the use of the co-decision procedure with the European Parliament, initiating reforms to EU decision-making which seek to increase transparency and

reduce discretion, the use of network forms of governance to increase the participation of private actors, including non-governmental organizations (NGOs), in the policymaking process, and enabling citizens jointly to define and share a view of the common good through the utilization of ‘deliberative democracy’ mechanisms (Skogstad 2003: 324). In the case of the policy process in financial services governance, one can look particularly at the first three strategies as potential sources of increased input legitimacy. The introduction of co-decision procedures in financial services sector policymaking can be clearly understood as increasing input legitimacy as it formally includes the only directly elected EU body, the European Parliament, in the process of policy creation. Second, the potential of increased transparency in the decision-making process is less consistent. This includes the potential to overcome a ‘democratic deficit by being more transparent, providing more opportunities for public participation, giving reasons for their decisions, and exercising less technical or administrative discretion’ (Skogstad 2003: 325). The third strategy, the inclusion of private and non-governmental actors into policy networks, is of particular interest. As we will see, European institutions have made a real attempt to include at least financial services actors in the structure of governance.

Whether consultation with outside actors has the potential to increase input legitimacy is contested. Not all scholars agree on the usefulness of direct consultation in enhancing input legitimacy. Michalowitz argues that the inclusion of ‘civil society’ does not necessarily improve legitimacy. She highlights the key problem as:

‘...the paradox that lobbying actors are generally perceived as rationalist, self interest-guided actors who may contribute to democratic decision making by inserting special interest views, but who do not strive for a common good themselves. For a European civil society that is able to contribute to the input legitimacy of the European political system however, actors are needed whose principal aim is to serve the common good by engaging in decision making’ (Michalowitz 2004: 147).

Furthermore, it has been argued that EU bodies do not necessarily encourage previously uninvolved citizens to become active but may actually further reinforce the involvement of those ‘citizens and groups who benefit from their intellectual and financial resources to try to influence EU politics and policies’ (Magnette 2003: 156). Magnette acknowledges though that this trend does not necessarily mean that the system is undemocratic because (1) widespread active citizenship is rare in most Western countries and (2) ‘all citizens benefit from the mobilisation and vigilance of the more active citizens among them’ (2003: 250-1).

Those arguments aside, there are a number of scholars that underscore that input legitimacy is enhanced by the inclusion of non-state actors' consultation and/or participation in policymaking (Héritier 1999; Lord and Beetham 2001; Lord 2001; Skogstad, 2003). Schmidt (2004) argues that one does not really see 'government *by* the people' as occurring through political participation in the EU but 'government *with* the people', which is achieved through consultation with organized interests. Government *with* the people can also be seen as enhancing both input and output legitimacy (by potentially improving the overall quality of emerging regulation). For example, Bowen asserts that business interest representation can act as a source of both input and output legitimacy at the sectoral level, though it functions more as part of output legitimacy at the systemic level (2003: 8).

Even if there is acceptance of consultation as part of input legitimacy, there is still some debate around the actual role that these actors and processes play. Some like Héritier (1999) assert that participation can act as a substitute to more traditional forms of government-based legitimacy. Others like Lord and Beetham (2001) argue that the innovative input legitimization strategies of the EU are constrained to a complementary role. For them, the development of a representative political system is still necessary because the minimum legitimacy requirements for states also apply to the Union directly. Despite the limits on the potential impact of this type of strategy, it is still worth examining as an attempt by EU institutions to be more inclusive.

Finally, as our analysis focuses largely on interactions that occur within a committee structure it is also important to briefly reflect on the role committee governance has on these legitimacy questions. The use of committees in the European policymaking process is not a new phenomenon and their impact on EU legitimacy has received specific attention from a number of different scholars (Rhinar 2002; Dehousse 2003; Egeberg, Schaefer and Trondal 2003). There appears to be agreement that the use of these committees raises important concerns around the areas of input legitimacy, particularly transparency and access. Schmidt (2004) argues that input legitimacy problems are exacerbated by the committee system. She highlights the inherent problems with assuming that 'governance "with *some* of the people" and possibly not "for *all* of the people" is meant to make up for the lack of government "by and of the people"' (Schmidt 2004: 985-6). In addition, Dehousse aptly highlights the paradox of committees, 'initially conceived as control devices, "comitology" committees are now increasingly perceived as transnational bureaucratic networks, which themselves need to be controlled' (2003: 810). As such, many elements and potential contributions of a comitology system remain contested. Joerges and Neyer (1999),

however, find that the comitology system does present the potential for a certain degree of ‘deliberative democracy’. Although Rhinard finds that the committee structure leads to the preference of system effectiveness over democratic legitimacy, he also acknowledges that as small, insulated groups these committees are highly suitable institutional mechanisms to pursue consensual and depoliticized decision-making allowing for extensive, ongoing consultation in an intimate atmosphere among actors from multiple levels of government and society (2002: 187).

2. POLICYMAKING IN THE FINANCIAL SERVICES SECTOR

2.1. The Policy Process

The integration of the financial services sector is often held up as one of the key successes of the European Union. Policy and regulation in this sector has a substantial history beginning in 1977 with the First Banking Directive. Yet by the 1990s the process seemed paralyzed by interstate conflict (Josselin 1997). In a *Euromoney* article, Shirreff reported at the time, ‘After nearly a decade of fanfare, the single European market for financial services is a ghost of what it should be’ (1999). It was not until late in the century that a new round of integration was kick-started by a combination of political and economic factors, including the adoption of the euro in 1999 and the increasing willingness of markets to operate cross-continent as indicated by the creation of Euronext, a pan-European exchange, in 2000. These developments were matched on the political side when the European Commission presented the Financial Services Action Plan (FSAP). The Action Plan was aimed at the integration of the continent’s securities markets and was ambitiously composed of 42 directives to be adopted in a period of five years. Despite the initial doubts, the FSAP is considered by most to be a success (European Commission 2005), in large part due to its efficiency. The legislative agenda of the FSAP at the European level has been completed within the agreed timeframe with 39 directives adopted.²

The efficiency of the FSAP was gained in large part through the introduction of a multistage regulatory process. The comitology apparatus emerged when the Committee of Wise Men, as created and called by the European Commission,

² Schaub, among others, point out that although the legislative part of the FSAP is complete, implementation and enforcement has not yet been undertaken partly diminishing the perceived success of the Action Plan (2005).

came together to propose ways by which to implement the FSAP. The Committee's final report in 2001 concluded that the previously existing policy process was often too slow in the adoption of legislation, that legislative texts tend to be ambiguous, that there are delays in the transposition process, that important issues were often left out of the legislation, that directives were difficult to update and that communication across regulators was still problematic (2001). As such, the Committee, chaired by Baron Lamfalussy, suggested a shift in policymaking to a four level comitology-based approach.

At the first level, the Council and Parliament agree upon broad directives, also referred to as essential measures, through the co-decision procedure. These directives are intended to set out the basis for regulation with most of the technical detail left to Level II legislation. After this, these directives are passed to the second level where European Commission and the European Securities Committee (ESC) set out the modalities of the Directive. The content of this second level of legislation is framed as technical or non-essential measures. However, it is at this level that much of the detail of the broad directives is elaborated.³ At the third level, the Committee of European Securities Regulators (CESR), formerly the Forum of European Securities Commissions (FESCO), is to provide advice to the ESC and the Commission on the elaboration of Level II regulations. CESR is also to facilitate consistent (day-to-day) implementation of Community law at the national level. Level III rules do not have any legally binding force, instead relying on softer measures and voluntary convergence. Finally, in the fourth level, national regulatory authorities implement the directive. It is the role of the Commission to ensure states' compliance with the legislation at this level.⁴

The ESC is thus created as part of this process. It is a committee of governmental actors from each member state operating within the European Commission. Primarily active in the second level of the comitology process, the ESC acts in both advisory and regulatory capacities. Its advisory functions revolve around advising the Commission on policy issues and potential Level 1

³ Significant regulatory decisions are still made at level II, even though they are presented as technical. For the first Level II measures (Market Abuse adopted in October 2003) it has been shown that Level II also involved policy decisions (European Parliamentary Financial Services Forum 2003). Avgerinos (2002) notes the distinction between where actual essential rule-making ends and implementation begins can be problematic making the distinction between political and technical ambiguous.

⁴ Because many of the measures of the FSAP are not yet implemented nationally, we will not focus on this level of decision-making. At Level IV, national governments must implement EU policies so the issue of legitimacy can be argued to be brought back to the traditional arena of the state.

developments. The regulatory function of this committee is 'to assist the Commission when it takes decisions on implementing measures under Article 202 of the EC Treaty' (European Commission 2005c). In essence this is the committee responsible for creating and implementing Level 2 regulation, which is still legally binding.

Also created to take an advisory and coordinating role in the Lamfalussy process was CESR. Created in 1997 the original forum, FESCO, was to informally encourage collaboration between the EU's different financial services sector regulators. The creation of CESR enhanced the activities of this group, making it a formal and integral part of the drafting of securities regulation at the European level. In particular, the European Commission requests formal advice from CESR on the potential structure of Level II legislation. Through this role, the advice of CESR is not only taken into account but in many cases seems to generally frame what the European Commission proposes to the ESC for Level II measures. The Secretary General of FESCO noted very early in the FSAP venture that 'FESCO is the necessary engine that links the broad directives adopted at the European level to the daily harmonized applications of such legislation at the domestic level' (Demarigny 2001: 134).⁵ CESR has been capable of establishing itself as a credible source of European authority for national regulators and market actors. For instance, Howard Davies, the Chairman of the Financial Services Authority, the British financial services sector regulator, stated, 'I am not sure that the directives, in practice, have been as spare as Lamfalussy envisaged. But what has certainly worked is the new regulatory network. CESR, as it is modestly known, has begun to be an effective deliverer of what we might call secondary legislation' (2003). In its coordinating role, CESR continues in its FESCO role of providing a forum for national regulators to discuss and potentially harmonize the national implementation of EU securities law. Most of our discussion about input legitimacy focuses on the work of this committee

The European Commission has started assessing the FSAP and the Lamfalussy process. It issued a Green Paper in the spring of 2005 on the future steps to be taken to further integration and a White Paper is forthcoming. It is expected that the White Paper will not propose a second version of the FSAP, focusing instead on left-over business from the first Action Plan with only a few minor new measures. Regulatory fatigue is said to have set in preventing another ambitious Plan as put forth at the turn of the millennium.

⁵ Authors' translation.

2.2. Output Legitimacy

The Lamfalussy process was created in large part to help increase the output legitimacy of policies in the FSAP.⁶ It sought to achieve this by increasing the efficiency and effectiveness of financial services policymaking by replacing a system that was perceived as ill-equipped to deal with the needs of a rapidly changing marketplace. In its 2001 Report, the Committee of Wise Men made the strong point that ‘the European Union has no divine right to the benefits of an integrated financial market. It has to capture those benefits by building an integrated European market... If it does not succeed, economic growth, employment and prosperity will be lower, and competitive advantage will be lost to those outside the European Union’ (2001: 8).

The Lamfalussy process has been seen as an effective way to increase efficiency. The EU has already extended its use, largely unaltered, to include the fields of banking and insurance. This indicates ‘that there is overall agreement among political actors concerned with financial markets that the process is a viable instrument through which decision-making can be made more efficient’ (Inter-Institutional Monitoring Group 2004: 37). In addition, the policy process is intended to increase the effectiveness of legislation by shifting much of the detail of directives to Level II. This is intended to allow for the easier altering of the details of regulation as the market evolves without having to renegotiate a new broad directive. Such an approach allows for flexibility while maintaining the overall broad substantive basis of the directive. Finally, the addition of more avenues for private consultation and participation can also be important for increasing output efficiency. Information obtained from individuals or groups that are affected by the legislation can be used to improve the design of policy and, therefore, their effectiveness.

However, there are still concerns which emerge within this process. For example, while the involved actors seem generally pleased with its efficiency over previous directive negotiations, recent consultations have indicated that market actors’ concerns have shifted towards the quality of legislation rather than the speed of its adoption. (Inter-Institutional Monitoring Group 2003: 11) Therefore, care must be given to ensure that effectiveness is maintained and not simply efficiency.

⁶ Effectiveness, as to the extent to which there actually is financial services sector integration, is hard to measure. Suffice to say for our purpose that integration in the financial services sector is uneven. The securities industry, for instance, tends to be more integrated than banking, money markets as well as the government and corporate bond markets are particularly integrated (Freixas *et al.* 2004).

2.3. Input Legitimacy

As argued in the theoretical section, there are three key institutional features which seek to enhance participation and representation of the public in the process: co-decision, transparency, and network governance. The first important attempt to achieve input legitimacy is the use of co-decision at Level I of the Lamfalussy process. Formalizing a potential veto point for the European Parliament, the EU's only directly elected body, the process does move slightly closer to ensuring input legitimacy through representation. Furthermore, recent reviews of the Lamfalussy process have highlighted that the creation of directives at Level I has not been marked by a conflictual relationship. The Inter-Institutional Monitoring Group (2004) found that there has been a significant improvement in co-operation between the Council, Commission and Parliament since the introduction of the new policy process. It highlights,

‘conscious efforts have been undertaken between the Secretariat of the Economic and Monetary Affairs Committee (ECON) of the European Parliament and DG Internal Market on the Commission side to work closely together and pick up emerging difficulties well in advance. The Group was informed that a positive new experience has been holding monthly meetings between the two services – thereby concretising the “systematic contacts on informal basis” suggested in the original report of the Wise Men’ (Inter-Institutional Monitoring Group 2004: 11).

The role of Parliament in creation of Level II legislation is more circumscribed. However, Parliament is informed of the ongoing policy process and it does issue opinions on proposed measures at this level. As the ESC's mandate states, ‘The Commission will inform the European Parliament on a regular basis of the ESC's proceedings acting under its regulatory capacity. It will send it at the same time and on the same terms as to the members of the ESC, the agendas for Committee meetings, the results of any votes and the summary records of meetings, as well as the list of the authorities to whom the representatives of the Member States belong’ (Commission of the European Communities 2001: 4). Specific to the Lamfalussy process is that the European Parliament receives more than just the ESC approved draft measures for review but is kept informed by the Commission of the drafts that the ESC considers (Inter-Institutional Monitoring Group 2003: 10). After the completion of a final draft regulation at this level the Parliament has one month to examine it. If the Parliament determines that the measures exceed the scope of the Level II mandate it issues a resolution stating this fact. However, this is not a formal veto or call-

back mechanism. Therefore, the level of accountability that the ESC has towards the Parliament is somewhat curtailed.⁷

A second input legitimization strategy is the increase of transparency. Since the introduction of the Lamfalussy process it is generally agreed among market participants and regulators that the transparency of the regulatory process has improved and this is an important feature of the process's success (Inter-Institutional Monitoring Group 2004; European Commission 2005b). The information made available, particularly via the internet, is quite extensive. In the case of the ESC, agendas and summaries of committee meetings are made available on the Europa website. In addition, they have begun to publish written explanations of those places where the secondary legislation adopted and CESR's advice differs. CESR also publishes consultation papers, some committee minutes and feedback papers on consultations on its website. In addition, it has formalized and made available its procedures for public consultation. The use of feedback statements and explanations of policy decisions also help to lower perceptions of an opaque and secretive decision-making process. Nonetheless there are still areas where transparency has not been achieved. For example, the Commission argues that transparency could be increased if CESR were to adopt a more transparent set of procedures for elaborating their advice and opinions (European Commission 2004: 9). There is, therefore, still room to increase the transparency and potentially the input legitimacy of the process.

The final input legitimization strategy within the Lamfalussy process is the inclusion of private actors and civil society. To address this we will look at the role of participation in the consultation mechanisms used in the Lamfalussy process. There are a number of access points with EU institutions promising consultation pre, during and post the implementation of a directive. The Inter-Institutional Monitoring Group's Second Report found that 'consultation has reached an appropriate level for all parties so that it is ensured that the views of market participants can be taken into account properly in the legislative and regulatory process' (2003: 5). It also finds that consultation activities at Level I are more extensive and systematic following the introduction of the Lamfalussy process, indicating more access points for private input and response to directives and regulations. The actual representativeness, however, is skewed heavily toward input from business actors over other potential stakeholders.

Providing a number of key points for participation at level II, CESR is also an important feature of input legitimacy primarily because it only forwards its advice

⁷ In practice, however, the process which has developed does appear to maintain the more collaborative nature of Level I. There has been no resolution of this type issued by the Parliament to date.

to the European Commission after having consulted with the market. There are essentially three formal participatory mechanisms used by CESR in consultation - consultation papers, expert and market committees and open hearings.

Respondent	Total # Responses	Average # Responses per Consultation	Percentage of Total Responses
European Industry/Business Associations (Financial Sector)	716	15.57	42.62%
Corporations	593	12.89	35.30%
European Industry/Business Associations (Non-financial)	118	2.57	7.02%
Governmental Actors (Non-European)	96 (29)	2 (1)	5.80% (1.72%)
Foreign and International Associations	94	2	5.60%
Individuals	30	0.7	1.79%
Investor/Shareholder Groups	12	0.3	0.71%
Consumer Groups	13	0.3	0.77%
Other Civil Society	8	0.2	0.48%
<i>Total</i>	<i>1680</i>	<i>36.53</i>	<i>100%</i>

Figure 1. Breakdown of CESR Consultation Responses.

The first, consultation papers, is the key mechanism used by CESR to consult with the public. To assess this mechanism each consultation was reviewed and respondents were divided into categories covering a range of business, governmental and other civil society actors. Overall, response rates have been solid with 1680 responses to 46 consultations held between October 2002 and 10 June 2005. However, the lack of civil society participation in this mechanism is clearly apparent even through a simple cursory review of the consultation responses. There are no responses from outside of business or governmental actors in twenty of the forty-six consultations. Out of all the responses received by CESR for all of its on-line consultation, only 63 were from individuals, consumer organizations, investor groups, organized labour, and any other group that is not a corporation or business association. That equates to less than four per cent of all responses to CESR's online consultations. This is compared to forty-two per cent of all responses coming from financial services sector industry associations within Europe. Another thirty-five percent of the respondents to the consultations were

corporations.⁸ The dominance of business groups in the consultation process is made apparent in Figure 1.

A second access point for participation is sitting on one of the market consultation committees created by CESR. CESR generally creates a market consultation committee of relevant players for each area of regulation it is working on. Members of these committees are drawn from a variety of market participants (including consumers and end-users) that spread across the member states. The role of these participants is to provide technical advice during the drafting of proposals and they are not to represent national or firm-specific interests. Currently there are seven active market consultation committees. The make-up of these committees demonstrates clearly once again that there are only a handful of non-corporate or business actors involved in these committees.⁹ CESR also established the overarching, permanent *Market Participants Consultative Panel* whose work focuses more broadly on the working priorities of the institution and assessment of developments in the market. This panel was established in June 2002 at the urging of the European Parliament (European Commission 2004). Its undertakes a number of different roles: to assist in the definition of priorities and work program, to provide commentary on how CESR carries out its work, and in particular how it puts into practice its *Public Statement of Consultation Practices*, to alert CESR to regulatory inconsistencies and suggest areas for further work to improve supervisory co-ordination, and finally to inform CESR on major developments and to identify new elements in financial markets (CESR 2005). The Panel meets three times a year. Individuals from shareholders groups are represented in two of the fifteen places, including the President of Euroshareholders (a main European level shareholders association).

A final method of consulting with industry and end-users used by both the ESC and CESR is holding open hearings around proposals in coordination with the internet consultations. The Commission has held a small number of such hearings, while CESR has held 23 open hearings since January 2003. The lack of

⁸ Similar statistics were compiled for the Committee of European Banking Supervisors (CEBS) and the Committee of European Insurance and Occupational Pension Supervisors (CEIOPS). These organizations were created more recently, in 2003, and therefore have produced fewer consultation documents. However, from the limited number of consultations the results appear similar to CESR.

⁹ Looking at EU committees on a broader scale we can find further confirmation of this trend toward business. Mahoney argues: 'Far from fostering balanced dialogue, the committee system reinforces the bias of the interest group community. Business remains the dominant force, making up approximately 72% of the groups (trade, business and professional) holding a committee position' (2004: 450). She notes a number of resource-based reasons for this, including the financial resources to maintain a Brussels-based office and staff to undertake a broader range of activities.

information about these meetings renders assessment based on representation difficult.

Interestingly, the EU bodies, particularly the Commission, have taken note of the lack of consumer and SME participation. To remedy this, in 2004 the Commission set up an independent expert forum – FIN-USE – to respond to financial services regulation proposals in the general Lamfalussy process from the perspective of users and consumers. The panel of 10 Commission appointed experts has a mandate ‘to strengthen the role of consumers and small businesses in the on-going evolution of the EU financial services sector’ (FIN-USE 2004). The forum is to respond to Commission initiatives which involve consumers and small businesses and the larger financial services industry as well as to identify and promote issues that affect these actors. In its first request, FIN-USE was asked to provide opinions on the Reports of four Expert Groups which reviewed the integration of financial services markets in Europe as the FSAP mandate came to an end. FIN-USE argued that on the whole reports largely ignore concrete user concerns. It also disagreed with the overall implications of the reports which imply that protecting user interests is best accomplished by competition, reducing barriers created by national protective legislation, encouraging supplier home country regulation and prioritizing self-regulatory tools. In responding to this, FIN-USE put forward ten general recommendations for further developments in financial services regulation that take into account user concerns and protection. They also provided a number of specific recommendations to each report (FIN-USE 2004). Therefore, FIN-USE could become a potentially important avenue particularly for consumers and other societal interests to assess the regulatory process of financial services, although this is not guaranteed.

3. DISCUSSION

It thus appears that the European Commission has made a real effort to improve input legitimacy in financial services sector policymaking. Despite these efforts, there remain some concerns in regards to popular participation. Certainly, there is more room for input in this policy field than exists in other areas of policymaking, especially if compared to monetary policy. As stated in the introduction, financial services sector policymaking at the national level also poses issues of legitimacy and democracy. The steps, therefore, taken by the EU are significant. Yet, as financial services sector integration starts to move away from the securities fields more towards banking, an area that affects directly a

broader segments of society, EU institutions will need to find ways to better incorporate end-users and consumers in decision-making.

There are a number of potential reasons that likely affect the current lack of participation from actors outside of the corporate sector in the regulation of financial services. One partial explanation for the general lack of engagement with a broader spectrum of society in this sector is the disconnection of the working of financial services from the popular discourse more generally. Finance is often a highly technical area which encourages a reliance on expert regulation and discourages an active non-business civil society from forming. Given the attention drawn because of the many corporate scandals in the previous few years and the stated importance of these initiatives to the overall integration of European by officials publicly this argument seems too simplistic. The world of financial markets has been thrust more into the general popular consciousness, creating opportunities for a wide-ranging civil society to emerge.

The reliance on technical language in the consultation process, particularly in the calls for response, would seem to encourage fewer non-industry responses. In many ways, the structural foundation for access exists but the discursive institutions within it may be minimizing its effectiveness. For example and as stated earlier, CESR is generally transparent in that it posts most of its documentation on its website. However, simply sifting through the document requires a certain technical expertise which may not be possessed by many of societal actors. In addition, over 30 of the 48 internet consultations by CESR were framed as technical discussions or as calls for evidence. One can assume that this is not a conscious attempt to close the discussion and exclude non-business dialogue with CESR given their stated consultation policy. However, CESR's proposals are largely reflections of the mandates passed down from the Commission, who in turn are attempting to technically flesh out broad directives passed through the Council and Parliament at Level I for the ESC. In essence, the very language of the comitology process works to discursively confine this level to a language of technical elements and the implementation techniques, although the decisions made often may have much broader effects. The Inter-Institutional Monitoring Group's most recent review of the Lamfalussy process has highlighted this problem. They note, "Where texts are highly technical, non-specialists with limited language skills are effectively shut out of the process" (2004: 24). In addition to language issues posed by the large scale use of technical jargon, consultations with consumers and SMEs are also hampered by the common practice of providing consultation documents through CESR only in English, placing the onus on national regulatory agencies to provide translation in many places.

Third, on a material level the lack of participation of social actors in financial services sector policymaking likely relates to the differences in available resources between business and non-business actors. Non-business groups often have fewer financial and administrative resources available to participate in different consultations.

The emphasis on speed and efficient implementation has also led to rather tight deadlines on some consultations, adding to the stress on resources. Even for business, the speed of CESR's consultations has posed some problems. There are a number of market actors who have indicated that short consultation and examination deadlines have limited the quality of interaction (Deutsche Bank 2005). In addition to this stress, non-business groups often need to keep an eye on a much larger scope of initiatives in a number of different sectors and directorates, stretching scarce resources even further. This does not hold as true for many of the business actors involved as they are often more specific in nature. This also does not hold as true for investor groups, who are more visibly active in the financial services consultative practice discussed above. On a systemic level, this structural disadvantage is well recognized in the academic literature on interest representation at the EU level (Mazey and Richardson 1999; Schmitter 2000; Greenwood 1997).

Even though there is a structure in place for open consultation with society in the Lamfalussy process, this has not directly translated into broad participation. Looking at groups that are actually involved, there is a noticeable lack of participation from consumers, labour and other social groups and a plethora of interaction from business interests. This is problematic when one considers the broader implications that financial services regulation has on economic features like the cost of capital, as well as the more direct elements of retail finance.

4. CONCLUSION

Returning to the original question – the extent to which the policy process facilitates or impedes the legitimacy of policymaking in the financial services sector – it is clear that the policy process in financial services does achieve a certain amount of both output and input legitimacy. The legislative agenda of the Financial Services Action Plan was implemented on time and the regulatory process favours consultation with market actors. However, complete implementation of measures across the Union remains a problem (impeding the possibility for the EU to fully profit from financial services sector integration) as is the inability of end-users and consumers to fully access the policy process.

It is obviously impossible to generalize the conducted analysis to the whole of policymaking in the EU. However, the findings obtained in the financial services sector suggest a real effort by the institutions of the Union to not only appear legitimate through output legitimacy, but to respond to critics and improve input legitimacy. Experimenting with new policy processes is obviously easier in technical fields that have active policy networks, as is the case in finance. However, such policy fields are also highly at risk of being exclusionary. In the case of finance, achieving inclusion is particularly important due to its central role for furthering economic integration and for the health of the general health of the economy. Broadly speaking, the banking sector is much more open to political debate than the securities field. Until the EU undertakes real integration in banking, groups representing larger social interest may simply be less interested in participating in policymaking. Nonetheless, if the EU is to increase its overall legitimacy, it is necessary for it to work towards ensuring inclusion across all policy fields. Our analysis suggests that in finance the EU is at least making progress towards that end. Since more generally financial policy is seen as among the policy fields that are most resistant to input legitimacy this progress is an especially significant challenge to those who see the EU as incapable of legitimizing itself.

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MAKING SENSE OF FISCAL RULES IN EMU

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ABSTRACT

In this paper we extend Nordhaus' (1994) results to an environment which is characterized by a single monetary authority and several fiscal bodies, as is currently the case in Europe in Economic and Monetary Union (EMU). We show two results. First, cooperation among national fiscal authorities is welfare improving only if they also cooperate with the central bank. If this condition is not satisfied, fiscal rules, such as those of the Maastricht Treaty and the Stability and Growth Pact, may work as coordination devices that improve welfare. Second, the fiscal authorities of the small countries participating in EMU will have no incentives to discipline themselves, since each of them faces a vertical monetary authority reaction function. Though it is well-known that fiscal authorities free-ride (see, e.g. Uhlig 2002), we prove this conventional wisdom in an original way, namely by using a modified version of the Nordhaus model. We also show that such a conclusion emerges precisely when the other well-established result of the Pareto superiority of fiscal leadership with respect to a non-coordinated (Nash) solution no longer applies (since with a vertical monetary authority reaction function the two equilibria coincide). The resulting policy-mix will therefore be inefficient, unless small countries coordinate their fiscal behaviour. Since that is unlikely, as they are expected to free-ride, we advocate fiscal rules to apply to small countries as well.

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1. INTRODUCTION

In this paper we analyze the interaction of European monetary and fiscal policies in the light of the clauses of the Maastricht Treaty and of the Stability and Growth Pact (SGP). Are the fiscal constraints that they have introduced useful coordination devices? Recent contributions, in particular that by Dixit and Lambertini (2003a), find that, if the monetary authority and the national fiscal authorities agree on the ideal output and inflation levels, an optimal outcome is obtained with no need for any form of coordination and regardless of differences in the relative weights given to the two objectives. We analyze this particular case of ‘symbiosis’, showing that the result is not replicated in a different model setup. In particular, we extend Nordhaus’ (1994) results to an environment which may represent the current European situation, which is characterized by a single monetary authority and several fiscal bodies. As a matter of fact, while in the US context the game between the Treasury and the Fed may produce results that are easily interpretable within the Nordhaus’ approach, such a model needs to be modified in order to analyze the game between the European Central Bank (ECB) and the different national treasuries. The recent enlargement of the European Union (EU) provides a further justification for our analysis. We consider an open economy and, in particular, the case of a two-country monetary union that, as we will argue below, can be taken as an approximation of a multiple country situation.

We consider macroeconomic policy with two instruments, monetary and fiscal policy, and having three objectives: price and fiscal stability, and full employment. Following Dixit and Lambertini (2003a), we assume that monetary and fiscal authorities share the same model of the economy and the same ideal targets, although they assign different weights to their objectives: the former cares more about inflation, while the latter is more concerned about unemployment.

In this paper we make two points. First, cooperation among national fiscal authorities is welfare improving only if they also cooperate with the central bank. When this condition is not satisfied, fiscal rules, such as those envisaged in the Maastricht Treaty and in the SGP, can act as welfare improving devices. Since we assume, like Nordhaus (1994), that the authorities target three objectives, this result applies even in the case, considered by Dixit and Lambertini (2003a), in which the monetary and fiscal authorities share the same ideal targets. Second, the fiscal authorities of the small countries participating in a monetary union will have no incentives to discipline themselves, since each of them faces a vertical monetary authority reaction function. Though it is well-known that fiscal authorities free-ride (see, for example, Uhlig 2002), we prove this conventional

wisdom in an original way, namely by using a modified version of the Nordhaus model

We also show that such a conclusion emerges precisely when the other well-established result of the Pareto superiority of a Stackelberg game with fiscal leadership with respect to a non-coordinated (Nash) solution (see for example Nordhaus 1994, Dixit and Lambertini 2001 and especially Lambertini and Rovelli 2003) no longer applies, since with a vertical monetary authority reaction function the two equilibria coincide. This will occur unless the small countries manage to coordinate their fiscal behaviour. Thus, to avoid free-riding, we also argue in favour of fiscal rules in the case of small countries.

The paper is organized as follows. First, we present a brief overview of the literature (section 2). The structure of the model and its main implications for the identical countries' case and the small country case are presented in section 3. Some concluding remarks summarize our analysis.

2. REVIEW OF THE LITERATURE

2.1. The Strategic Game between Central Bank and Fiscal Authority in a Closed Economy

Nordhaus (1994) considers the strategic relationship between a fiscal and a monetary authority aiming at optimally choosing their respective instruments in order to minimize their loss functions. When a Nash game is played, he finds that the lack of cooperation is responsible for an inefficient policy mix, often observed in reality, resulting in an excessively restrictive monetary and an excessively expansionary fiscal policy.² This result is explained by the different weights assigned to the objectives of the two authorities, implying that the fiscal authority tries to fight unemployment by means of an expansionary policy, while the central bank reacts by means of a contractionary policy to keep inflation under control.

He also shows that the solution of a Stackelberg game (with the fiscal authority playing as a leader), usually Pareto dominates the Nash outcome.³ As a

² The same conclusion is reached by Carraro (1986) and Tabellini (1987). Hughes Hallett and Petit (1990) also underline the costs deriving from the lack of cooperation between fiscal and monetary policy. They find, however, that the fiscal expansion - monetary restriction policy mix is efficient, and results from a cooperative game in which the government dominates and the central bank is allowed the freedom to fight inflation.

³ Lambertini and Rovelli (2003) show that the Stackelberg solution always Pareto dominates the Nash one, independently of who is the leader of the game.

matter of fact, when the fiscal authority takes the central bank's reaction function into account⁴, it will act in a less expansionary way, so as to allow the central bank to follow a less restrictive policy.⁵

The consolidation effort of a fiscal authority, however, might be reduced (or even prevented) as a consequence of a particular belief by the central bank, for example that inflation is only determined by money. In that case, the monetary authority would not respond to a fiscal contraction with a monetary expansion, simply because it does not believe that such a contraction may reduce inflation. Alternatively, the lack of fiscal consolidation might be due to the fact that the central bank follows a fixed interest rate rule, irrespective of the policy followed by the government. The same outcome would be found when the fiscal authority fears that the monetary authority's reaction may be slow. This outcome would arise with a rather conservative central bank that would need to observe a low rate of inflation before agreeing on reducing the interest rate. This point is considered by Nordhaus (1994). He shows how a deficit reduction will be very costly in terms of lower aggregate demand and higher unemployment, when monetary policy is 'results-oriented' and responds to a fiscal consolidation with a delay. Of course, as long as the instances above imply a deflation, the prescription of rigid fiscal rules would be far from justified (Sargent and Wallace 1981).

Other reasons provide some scepticism regarding the discipline of the fiscal authorities and lead to arguments in favour of the imposition of fiscal rules. As a matter of fact, many authors argue that governments find ways to influence the decisions of a formally independent central bank. This influence may be either direct (sheer political pressure) or indirect (appointment of board members), so that discrepancies between constitutional (or statutory) and actual central bank

⁴ Nordhaus (1994) defines such a case as characterized by a monetary rule, arguing that the fiscal authority would be obliged to optimize its utility function, subject to the rules strictly followed by an independent and conservative central bank.

⁵ The Stackelberg solution, though being Pareto superior to the Nash one, is worse than the cooperative outcome. As a matter of fact, cooperation between fiscal and monetary authorities would allow them to choose a solution included between their respective bliss points. In opposition to this conclusion, however, Blinder (1983) finds *coordination* (for reasons that will be explained below, we would find more appropriate to talk about *cooperation*) between monetary and fiscal policy both difficult to implement and not necessarily conducive to superior outcomes. In his view, the possibility of blocking each other's options should be preserved, as made clear by the short example quoted in Carraro (1986). The example refers to a car that is used in learning how to drive. While it would seem efficient to endow just one guide with brakes, there may be some situations in which the availability of a second brake might turn out to be particularly useful. The example seems to reflect particularly well the fact that, over the last twenty years, the US has almost never followed both restrictive monetary and fiscal policies: when fiscal policy was expansionary, monetary policy has been restrictive and vice versa.

independence may arise (Beetsma and Bovenberg 1998; Cuckierman 1994).⁶ Moreover, even when independence is granted the central bank might not be conservative enough to be able to commit to tight monetary policies. This is why most institutional arrangements not only include central bank independence but also conservativeness, the former not necessarily implying the latter.

Central bank conservativeness, however, may still not be enough to induce fiscal discipline. As a matter of fact, by considering a model in which public debt enters the objective function of the fiscal authorities, Beetsma and Bovenberg (1997a) show that in the presence of political distortions (the fiscal authority is myopic, i.e. it is more impatient than society) or opportunistic behaviour (the fiscal authority cares less about inflation than society does and it does not care sufficiently about debt stabilization), a conservative central bank will not be capable to reduce the public debt bias. Also, when considering a cooperative equilibrium, central bank conservativeness might not be enough to guarantee fiscal discipline, as proved, among others, by Van Aarle, Bovenberg and Raith (1995). They show that a conservative central bank may exert a perverse effect on the fiscal authority, since the aggregate concern for debt stabilization is reduced, and conclude, therefore, in favour of the imposition of fiscal rules.

2.2. The Strategic Game between Central Bank and Fiscal Authorities in a Monetary Union

When considering a monetary union, characterized by a single central bank and several national fiscal authorities, some further arguments justify the introduction of fiscal rules, like those contained both in the Maastricht Treaty and in the SGP. Bovenberg et al. (1991) describe several channels through which monetary unification can make fiscal policy more expansionary. Both the cost of borrowing and the burden of public debt on the domestic economy are not internalized since they are partially shifted to other countries.⁷ Country risk is removed, given the implicit insurance resulting from the participation in a currency union where economic and financial stability is a public good. In addition to that, the elimination of currency risk encourages the residents of other

⁶ The presence of a high level of public debt provides an additional reason for running expansionary monetary policies in order to reduce its burden (Beetsma and Bovenberg 1997b). Contrary to this conclusion, in the Nordhaus model central bank independence is to be blamed for public debt explosion.

⁷ Aizenman (1992, 1993) shows that a monetary union with decentralized fiscal decision making produces both an inflationary bias and excessive public spending (it should be noted that in this case the inefficient policy mix is made of expansionary monetary and fiscal policies).

countries to invest in government debt, so that fiscal authorities can easily borrow on the international markets to finance their expenditure. Moreover, since a common monetary policy cannot be used to face country-specific shocks, fiscal policy may have to do the job. In other words, the disciplining market mechanism, that might work when a fiscal authority faces its domestic central bank, fails (Papadia and Ruggiero, 1999). Similar considerations are made by Beetsma and Bovenberg (1999), in line with the findings in Chari and Kehoe (1998). In a closed economy, when the credibility of the central bank is assumed to be a public good, in the presence of a non-credible central bank, the fiscal authority restrains debt accumulation in order to enhance the credibility of future monetary policies. In a monetary union, however, the separate fiscal authorities may not fully internalize the cost of the additional inflation resulting from the need to reduce the real value of the public debt, since part of these costs spills over to other countries. In such a situation, the second best outcome can be achieved by supplementing the central bank with debt targets on the fiscal authorities, so as to alleviate the free-rider problem.⁸ The issue of free-riding is also addressed by Uhlig (2002), who shows, among others, that in EMU ‘each of the twelve fiscal authorities will generally see itself only as a small part of the whole, and attach only minor importance to its own impact on European monetary policy, effectively free-riding in its fiscal policy choices on the consequences of monetary policy for the whole of Europe’. As a result, ‘every country ends up free-riding, reaching an overall worse outcome than if the fiscal authorities had agreed beforehand on coordinating their policies’ (Uhlig 2002: 33).

Dixit (2001) and Dixit and Lambertini (2001, 2003b) provide an additional reason for the introduction of fiscal constraints in a monetary union. Fiscal rules are useful precisely to make the central bank’s commitment to low inflation credible.⁹ They show that with monetary leadership (i.e. when the monetary authority takes into account the fiscal authorities’ reaction functions), fiscal discretion may destroy monetary commitment. When fiscal authorities do not care about monetary independence, fiscal policy will keep being expansionary even under the threat of a restrictive monetary policy, so that monetary authorities end up acting in an expansionary way in order to avoid a debt explosion. With fiscal leadership, on the other hand, the fiscal authorities will take into account the monetary authority’s reaction function, so that fiscal policy will become more moderate. This result is also obtained, as we have seen, by Nordhaus (1994), when considering the game between a monetary and a fiscal national authority.

⁸ In line with these results, Casella (1992), Alesina and Grilli (1993) and Bayoumi (1994) show that the attractiveness of entering a currency union decreases with the number of participants.

⁹ Similar considerations have been made by Artis and Winkler (1998).

By extending the model proposed by Tabellini (1986), Van Aarle, Bovenberg and Raith (1997) analyze the strategic game between domestic treasuries and a central bank aiming at reducing public debt. Contrary to the results mentioned above, they show that, when considering feedback strategies,¹⁰ debt stabilization happens more quickly with a common central bank than with separate ones. The reason for such a conclusion is that any fiscal authority participating in the monetary union knows that, if it does not adjust, the central bank will not react to such an imbalance, since it will only respond to a generalized higher public debt. In other words, in a monetary union the fiscal authority of any single country has a weaker strategic position vis-à-vis the central bank when compared to the case in which it faces a national central bank. Any national treasury caring about the size of public debt will in this case reduce its fiscal deficit. This effect vanishes as soon as countries cooperate, since this situation replicates the one in which a single treasury faces a single central bank. As long as governments fail to cooperate moving to a monetary union improves fiscal discipline and monetary stability, thereby making the need for the imposition of fiscal rules less stringent.¹¹

The attempt to coordinate monetary and fiscal policy in order to check for inflation while assuring an adequate output growth is common to many of the Organisation for Economic Cooperation and Development (OECD) countries, where monetary tightening is typically accompanied by fiscal relaxation (Hughes Hallet 2001). In Europe this was the case up to 1990.¹² During the years preceding EMU, however, such a relationship became weaker, with monetary policy only reacting in an expansionary way to public debt rather than deficit reductions (European Commission 2001). The overall picture did not change with the start of EMU. The ECB is committed to pursue price stability and to satisfy self-imposed monetary targets, while the fiscal authorities have to abide by the rigid fiscal rules contained both in the Maastricht Treaty and in the SGP. In other words, a strategic interaction between the monetary authority and the fiscal treasuries seems to be prevented by the institutional rules to be followed: 'We do know that [the ECB] is not going to pay much attention to fiscal policy or to fiscal-monetary coordination' (Hughes Hallet 2001: 11).

The observation made by Hughes Hallett might suggest that it does not make sense to consider a strategic relationship between the ECB and the national

¹⁰ When considering a dynamic game, while in the case of open loop strategies a player takes the opponent's action as given, in the case of a feedback (closed loop) strategy a player takes into account the opponent's reaction function.

¹¹ A similar conclusion is reached by Beetsma and Bovenberg (1998).

¹² Although some authors observe that central banks, engaged in restrictive policies aimed at reducing the inflation rate, were slow and reluctant to compensate for the consolidation policies followed by fiscal authorities.

treasuries simply because the ECB statute does not contain any element inferring that monetary policy would be more expansionary when fiscal policy became tight enough. Such a condition, however, is not present in the US Fed's statute either, but the available evidence provides a clear indication of such a strategic relationship. Moreover, 'the aggregate fiscal stance deserves special attention in EMU context, since it directly affects the policy-mix at the European level, and therefore is one of the elements taken into account in setting monetary policy' (European Commission 2001: 19).

This point of view is strengthened when considering the declarations, reminiscent of the strategic relationship between the Fed and the Treasury in the US, that accompanied the interest rate reductions by the ECB in 2003: 'I think that we are credible enough for people to believe that we will deliver what we promise to deliver. And now it is the turn of the governments to do the same thing' (Duisenberg 5 June 2003, ECB Press Conference).

In the following paragraph we present the model in which we analyze the strategic interaction between the ECB and national fiscal authorities in Europe. Our model allows us to show, first, that, when considering the fiscal authorities of two identical countries, cooperation between them is welfare improving only if they also cooperate with the central bank. Second, the smaller the single country compared to the rest of the monetary union, the smaller its incentive is to pursue fiscal discipline. These two factors justify the introduction of fiscal rules.

3. THE MODEL

We consider a monetary union formed by two countries. In each country the fiscal authority is responsible for fiscal policy, represented by the government surplus/Gross National Product (GNP) ratio¹³, S_i , where subscript $i = 1, 2$ refers to country 1 and 2 respectively. The union's central bank is responsible for monetary policy, conducted by setting the interest rate, r . The model is a single-period one. The inflation-unemployment trade off is represented by a standard short-run Phillips curve, adapted to the two country framework, as in eq. (1), where π and π^e are the union's actual and expected inflation rate, respectively; u_i and u_i^n are the actual and natural unemployment rate in country i , respectively; δ and ε are the

¹³ We follow Nordhaus (1994) in choosing the structural fiscal surplus ratio, even if the total and the primary surplus could be used (the latter would be the preferable choice in a multi-period framework, since it would eliminate interest payments as an additional element of policy interaction).

parameters indicating the weight of country 1 and country 2, respectively, in the monetary union, such that $0 \leq \delta \leq 1, 0 \leq \varepsilon \leq 1$ and $\delta + \varepsilon = 1$:

$$\pi = -\alpha'[\delta(u_1 - u_1^n) + \varepsilon(u_2 - u_2^n)] + \pi^e. \quad (1)$$

Following Nordhaus (1994), we assume that the expected rate of inflation is given by a backward looking component, π^B , i.e. past inflation, and a forward looking one, π , i.e. actual inflation:

$$\pi^e = \omega\pi + (1 - \omega)\pi^B, \quad (2)$$

where ω is a parameter expressing the weight of the forward looking component. By substituting from eq. (2) into eq. (1), for $0 \leq \omega < 1$, we obtain:

$$\pi = -\alpha(\delta u_1 + \varepsilon u_2) + k, \quad (3)$$

where $\alpha = -\frac{\alpha'}{(1 - \omega)}$ and $k = -\frac{\alpha'}{(1 - \omega)}(\delta u_1^n + \varepsilon u_2^n) + \pi^B$.¹⁴

Monetary and fiscal policies are assumed to affect aggregate demand and unemployment, as shown in eqs. (4) and (5):¹⁵

$$u_1 = \mu_1 S_1 + \nu_2 S_2 + \mu_r r, \quad (4)$$

$$u_2 = \mu_2 S_2 + \nu_1 S_1 + \mu_r r, \quad (5)$$

where μ_1 and ν_2 are the multipliers of u_1 with respect to S_1 and S_2 ; μ_2 and ν_1 are the multipliers of u_2 with respect to S_2 and S_1 ; ¹⁶ and μ_r is the multiplier of both u_1 and u_2 with respect to r .¹⁷

By substituting eqs. (4) and (5) into eq. (3), one gets:

¹⁴ In the new classical case, with $\omega = 1$, the actual unemployment rate is equal to the natural one.

¹⁵ In the new classical case, instead, unemployment is unaffected by monetary and fiscal policy in the absence of shocks.

¹⁶ We assume that fiscal spillovers are positive, which seems likely in the two-country framework we adopt. The effects of the existence of a negative spillover are briefly indicated when deriving the results.

$$\pi = -\alpha[(\delta\mu_1 + \varepsilon\nu_1)S_1 + (\varepsilon\mu_2 + \delta\nu_2)S_2 + \mu_r r] + k. \quad (6)$$

Still following Nordhaus (1994), we assume that the loss function of the monetary authority depends on the unemployment rate, the inflation rate and the growth rate, while the loss functions of the fiscal authorities have a further argument, the government surplus/GNP ratio. In the short-run, the growth rate is a function of the investment ratio, which is given by the private saving ratio plus the government saving ratio. As in Nordhaus (1994), we make the simplifying assumption that the private saving ratio is unaffected by monetary and fiscal policies, so that the growth rate is a function of the government saving rate. Both authorities are thus assumed to target unemployment, inflation and government surplus. Their loss functions are assumed to be quadratic and separable:¹⁸

$$L^{F_1} = (u_1 - u^*)^2 + \beta_1^*(\pi - \pi^*)^2 + \gamma_1^*(S_1 - S^*)^2 \quad (7)$$

$$L^{F_2} = (u_2 - u^*)^2 + \beta_2^*(\pi - \pi^*)^2 + \gamma_2^*(S_2 - S^*)^2 \quad (8)$$

$$L^M = (\delta u_1 + \varepsilon u_2 - u^*)^2 + \beta^{**}(\pi - \pi^*)^2 + \gamma^{**}(\delta S_1 + \varepsilon S_2 - S^*)^2, \quad (9)$$

where β and γ are parameters, the superscripts M , F_1 and F_2 have obvious meanings, and the superscript $*$ of a variable denotes the target value for the fiscal and monetary authorities.¹⁹

¹⁷ The assumption of an identical reaction to the interest rate is made in order to simplify the derivation of the results and does not affect them in a substantial way.

¹⁸ It should be noted that the inclusion of the fiscal target in the loss function of the monetary authority does not affect the results. Its inclusion in the loss function of the fiscal authorities is instead crucial to them. Many authors, apart from Nordhaus (1994), include fiscal policy in the fiscal authority's objective function. Uhlig (2002), for example, includes the squared deviation of fiscal policy from a random fiscal budget shock, to indicate the desire of governments to run fiscally balanced budgets; Lambertini and Rovelli (2002, 2003) include fiscal policy since stabilization policies are assumed to be costly for at least two reasons: the first one has to do with long run considerations, i.e. the desire to avoid debt accumulation or debt decumulation; the second one refers to the optimal level of private vs. public expenditures; Dixit and Lambertini (2003b) introduce the fiscal instrument in the social loss function (to be optimized by the fiscal authority) to take the connected deadweight loss into account. There are also examples of authors, other than Nordhaus (1994), that include fiscal policy variables in the monetary authority's objective function: Beetsma and Uhlig (1999), for example, include public debt in the objective function of the central bank.

¹⁹ Target unemployment can be different from the natural rate, as, for instance, in the case of monopolistic competition (see Dixit and Lambertini 2001).

Following Dixit and Lambertini (2003a), we assume that the target values for unemployment and inflation rates are the same for all authorities. However, since the loss function of the monetary and fiscal authorities also includes a target for the fiscal surplus, in our model, like in Nordhaus (1994), the number of targets is larger than the number of instruments, so that Dixit and Lambertini's result of symbiosis does not hold anymore. The assumption that fiscal and monetary authorities agree on the ideal targets for unemployment, inflation and fiscal surplus is easily justified by considering that the two countries of our model in the first place agreed on joining a monetary union. Moreover, still in line with the reasoning followed by Dixit and Lambertini (2003a), we find it reasonable to assume that the common central bank reflects those targets given that the two countries have agreed to delegate to it the conduct of monetary policy. We find it reasonable to assume, however, that the two countries differ from one another and with respect to the central bank as to the relative cost of the deviation from their targets. In particular, we have in mind a situation in which $\beta_1^* \neq \beta_2^*$ and $\beta^{**} > \beta_i^*$, $i = 1, 2$.

3.1. The Reaction Functions

Let us first derive the reaction functions for the monetary and fiscal authorities.

The reaction function of the monetary authority is obtained by substituting into eq. (9) from eqs. (1)-(5), by differentiating with respect to r and by imposing the optimality condition $\frac{\partial L_M}{\partial r} = 0$, which yields:

$$S_1 = -\frac{(\varepsilon\mu_2 + \delta\nu_2)}{(\delta\mu_1 + \varepsilon\nu_1)}S_2 - \frac{\mu_r}{(\delta\mu_1 + \varepsilon\nu_1)}r + \frac{u^* + \alpha\beta^{**}(k - \pi^*)}{(\delta\mu_1 + \varepsilon\nu_1)(1 + \alpha^2\beta^{**})}. \quad (10)$$

As for the fiscal authority of country 1, by substituting into eq. (7) from eqs. (1)-(5) and by setting $\frac{\partial L_{F_1}}{\partial S_1} = 0$, we obtain:

$$\begin{aligned}
S_1 = & -\mu_r \frac{\mu_1 + \alpha^2 \beta_1^* (\delta\mu_1 + \varepsilon\nu_1)(\delta + \varepsilon)}{\mu_1^2 + \alpha^2 \beta_1^* (\delta\mu_1 + \varepsilon\nu_1)^2 + \gamma_1^*} r + \\
& - \frac{\mu_1\nu_2 + \alpha^2 \beta_1^* (\delta\mu_1 + \varepsilon\nu_1)(\varepsilon\mu_2 + \delta\nu_2)}{\mu_1^2 + \alpha^2 \beta_1^* (\delta\mu_1 + \varepsilon\nu_1)^2 + \gamma_1^*} S_2 + \\
& + \frac{\mu_1 u^* + \alpha\beta_1^* (\delta\mu_1 + \varepsilon\nu_1)(k - \pi^*) + \gamma_1^* S^*}{\mu_1^2 + \alpha^2 \beta_1^* (\delta\mu_1 + \varepsilon\nu_1)^2 + \gamma_1^*}.
\end{aligned} \tag{11}$$

By substituting into eq. (8) from eqs. (1)-(5) and by setting $\frac{\partial L_{F_2}}{\partial S_2} = 0$, we obtain the reaction function of the fiscal authority of country 2:

$$\begin{aligned}
S_2 = & -\mu_r \frac{\mu_2 + \alpha^2 \beta_2^* (\delta\nu_2 + \varepsilon\mu_2)(\delta + \varepsilon)}{\mu_2^2 + \alpha^2 \beta_2^* (\delta\nu_2 + \varepsilon\mu_2)^2 + \gamma_2^*} r + \\
& - \frac{\mu_2\nu_1 + \alpha^2 \beta_2^* (\delta\mu_1 + \varepsilon\nu_1)(\delta\mu_2 + \varepsilon\nu_2)}{\mu_2^2 + \alpha^2 \beta_2^* (\delta\nu_2 + \varepsilon\mu_2)^2 + \gamma_2^*} S_1 + \\
& + \frac{\mu_2 u^* + \alpha\beta_2^* (\varepsilon\mu_2 + \delta\nu_2)(k - \pi^*) + \gamma_2^* S^*}{\mu_2^2 + \alpha^2 \beta_2^* (\delta\nu_2 + \varepsilon\mu_2)^2 + \gamma_2^*}.
\end{aligned} \tag{12}$$

This is a three-player game that we need to simplify in order to obtain easily interpretable results. There are two ways to simplify this game. The first is to assume perfect symmetry between the two countries that are thus considered to be identical. We develop this case formally in the next section. The second is based on the hypothesis of a major asymmetry between the two union members – a large country and a small one. This hypothesis allows us to consider the game between a single country and the central bank. From the perspective of the large country, since the variables and behaviour of the small one are virtually irrelevant, the game resembles that of a closed economy, as in Nordhaus (1994). In section 3.3 we concentrate our analysis on the game between a small country and the union's central bank.²⁰

²⁰ Note that in the new classical case, since monetary and fiscal policies do not affect the unemployment rate, eq. (4), eq. (5) and eq. (6) are replaced by: $p = -[\delta(\mu_1 + \nu_1)S_1 + \varepsilon(\mu_2 + \nu_2)S_2 + 2\mu_r r]$. Since unemployment is predetermined, its coefficient can be set to zero in the utility function.

3.2. Identical Countries

Let us first consider the case in which the two union member countries are identical: $\mu_1 = \mu_2 = \mu_s; v_1 = v_2 = v_s; \delta = \varepsilon = \frac{1}{2}$.

3.2.1. The Case of Non-Cooperative Fiscal Authorities

As for the monetary authority, building on the assumptions above and assuming, without loss of generality, $(\mu_s + v_s) = 1$, $u = \frac{u_1 + u_2}{2}$ and $\pi^* = -\alpha u^+ + k$ (for this last assumption see Nordhaus, 1994), calling u^+ the unemployment rate corresponding to the desired inflation rate π^* , eq. (10) becomes:

$$S_1 = -S_2 - 2\mu_r r + \frac{2(u^* + \alpha^2 \beta^{**} u^+)}{1 + \alpha^2 \beta^{**}}. \quad (13)$$

Since we assume that the two countries are symmetric, we set $S_1 = S_2 = S$, which yields:

$$S = -\mu_r r + \frac{u^* + \alpha^2 \beta^{**} u^+}{1 + \alpha^2 \beta^{**}}, \quad (14)$$

which is the reaction function for the monetary authority.

As for the fiscal authority, by applying the restrictions above to eq. (11), we obtain:

$$S_1 = -\mu_r \frac{2\mu_s + \alpha^2 \beta_1^*}{2\mu_s^2 + \frac{\alpha^2 \beta_1^*}{2} + 2\gamma_1^*} r - \frac{2\mu_s v_s + \frac{\alpha^2 \beta_1^*}{2}}{2\mu_s^2 + \frac{\alpha^2 \beta_1^*}{2} + 2\gamma_1^*} S_2 + \frac{2\mu_s u^* + \alpha^2 \beta_1^* u^+ + 2\gamma_1^* S^*}{2\mu_s^2 + \frac{\alpha^2 \beta_1^*}{2} + 2\gamma_1^*}, \quad (15)$$

which is the reaction function for the fiscal authority of country 1; symmetrically, for country 2 eq. (12) becomes:

$$S_2 = -\mu_r \frac{2\mu_s + \alpha^2 \beta_2^*}{2\mu_s^2 + \frac{\alpha^2 \beta_2^*}{2} + 2\gamma_2^*} r - \frac{2\mu_s v_s + \frac{\alpha^2 \beta_2^*}{2}}{2\mu_s^2 + \frac{\alpha^2 \beta_2^*}{2} + 2\gamma_2^*} S_1 + \frac{2\mu_s u^* + \alpha^2 \beta_2^* u^+ + 2\gamma_2^* S^*}{2\mu_s^2 + \frac{\alpha^2 \beta_2^*}{2} + 2\gamma_2^*}. \quad (16)$$

However, recalling our assumption that the two countries are identical so that $S_1 = S_2 = S$, we can derive a unique reaction function for the fiscal authority:²¹

$$S = -\mu_r \frac{2\mu_s + \alpha^2 \beta^*}{2\mu_s + \alpha^2 \beta^* + 2\gamma^*} r + \frac{2\mu_s u^* + \alpha^2 \beta^* u^+ + 2\gamma^* S^*}{2\mu_s + \alpha^2 \beta^* + 2\gamma^*} \quad (17)$$

The coordinates of the Nash equilibrium (NN) are obtained by considering together eq. (14) and eq. (17):

$$r_N^{NC} = \frac{2(\gamma^* - \mu_s \beta^{**} \alpha^2) + \beta^* \alpha^2}{2\gamma^* (1 + \beta^{**} \alpha^2)} u^* + \frac{(2\mu_s + 2\gamma^*) \beta^{**} \alpha^2 - \beta^* \alpha^2}{2\gamma^* (1 + \beta^{**} \alpha^2)} u^+ - \frac{S^*}{\mu_r} \quad (18)$$

$$S_N^{NC} = -\frac{(1 - 2\mu_s) \beta^* \alpha^2}{2\gamma^* (1 + \beta^{**} \alpha^2)} u^* + \frac{(1 - 2\mu_s) \beta^* \alpha^2}{2\gamma^* (1 + \beta^{**} \alpha^2)} u^+ + S^*. \quad (19)$$

As it is easy to show, fiscal leadership generates a result that is Pareto superior to the Nash one, corresponding to a less expansionary monetary stance. Minimizing eq. (7) subject to the constraint of the monetary authority reaction

²¹ Note that v_s does not appear in the monetary and fiscal authorities' reaction functions, so that the sign of the fiscal policy spillover does not affect the result.

function, eq. (14), one obtains the following coordinates for the Stackelberg equilibrium:

$$r_S^{NC} = \frac{u^* + \alpha^2 \beta^{**} u^+}{\mu_r (1 + \alpha^2 \beta^{**})} - \frac{S^*}{\mu_r}. \tag{20}$$

$$S_S^{NC} = S^*. \tag{21}$$

The result is similar to the one obtained in Nordhaus (1994) for a closed economy and in Dixit and Lambertini (2001) for a monetary union. Figure 1 represents the situation described above. This Stackelberg equilibrium coincides with the bliss point of the monetary authority (see section 3.2.3).

If $u^* < u^+$, i.e. if the target for unemployment is lower than the one compatible with the Phillips curve constraint, given that $\beta^{**} > \beta_i^*$ by assumption and given that it is reasonable to argue that μ_s has a value which is most likely greater than 0.5, it is possible to conclude that $S_N^{NC} < S_S^{NC}$ and $r_N^{NC} > r_S^{NC}$.

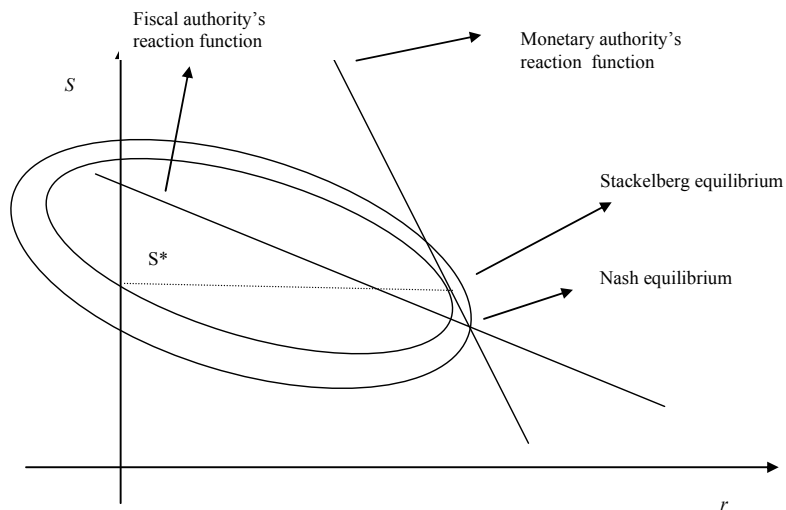


Figure 1. The Nash equilibrium and the Stackelberg equilibrium with fiscal leadership with a negatively sloped central bank's reaction function (identical countries).

It should be observed that in the case of fiscal leadership the equilibrium is characterized by a budget surplus corresponding to the target desired by the fiscal authorities, irrespective of the cost due to deviations from it.

3.2.2. The Case of Cooperative Fiscal Authorities

After considering the case in which the two fiscal authorities act non-cooperatively, let us consider the case in which they do cooperate. In such a situation they minimize the following joint loss function:

$$L^F = (u - u^*)^2 + \beta^*(\pi - \pi^*)^2 + \gamma^*(S - S^*)^2. \quad (22)$$

By applying the procedure above and by setting $\frac{\partial L^F}{\partial S} = 0$, one obtains the fiscal reaction function in the cooperative case:

$$S^C = -\mu_r \frac{(1 + \alpha^2 \beta^*)}{(1 + \alpha^2 \beta^* + \gamma^*)} r + \frac{1}{(1 + \alpha^2 \beta^* + \gamma^*)} u^* + \frac{\alpha^2 \beta^*}{(1 + \alpha^2 \beta^* + \gamma^*)} u^+ + \frac{\gamma^*}{(1 + \alpha^2 \beta^* + \gamma^*)} S^*, \quad (23)$$

where S^C indicates the fiscal authorities' optimal surplus response in the cooperative case.

Note that the slope of the fiscal authority's reaction function in the cooperative case is higher, in absolute value, than in the non-cooperative one, since the effect of a change in r on the other country is also taken into account. The monetary authority's reaction function, instead, remains the same as in the non-cooperative case and is always steeper than the fiscal one. This is definitely true if $\gamma_s > 0$, which is likely the case in this two-country setup.

The coordinates of the Nash equilibrium when the fiscal authorities do cooperate with each other are obtained by solving the system formed by eq. (14) and eq. (23):

$$r_N^C = \frac{\alpha^2(\beta^* - \beta^{**}) + \gamma^*}{\gamma^*(1 + \alpha^2 \beta^{**})} \mu_r u^* - \frac{\alpha^2(\beta^{**} + \gamma^* - \beta^*)}{\gamma^*(1 + \alpha^2 \beta^{**})} \mu_r u^+ - \frac{1}{\mu_r} S^* \quad (24)$$

$$S_N^C = \frac{\alpha^2(\beta^* - \beta^{**})}{\gamma^*(1 + \beta^{**}\alpha^2)} u^+ + S^*. \quad (25)$$

As for the Stackelberg equilibrium, it is easy to show that the result is analogous to that obtained in the non-cooperative case.

3.2.3. The Bliss Points

The positions of the bliss points depend upon all parameters. In keeping with our initial assumptions, let us consider the case analyzed by Nordhaus (1994). For simplicity, let us assume that the fiscal and monetary authorities' utility functions display equal parameters, except $\beta^{**} > \beta^*$. By evaluating the reaction functions at $S = S^*$, from eq. (17) we obtain:

$$r^{BF} = -\frac{S^*}{\mu_r} + \frac{2\mu_s u^* + \alpha^2 \beta^* u^+}{(2\mu_s + \alpha^2 \beta^*) \mu_r}; \quad (26)$$

from eq. (23) we obtain:

$$r^{BFc} = -\frac{S^*}{\mu_r} + \frac{u^* + \alpha^2 \beta^* u^+}{(1 + \alpha^2 \beta^*) \mu_r}, \quad (27)$$

and from eq. (14):

$$r^{BM} = -\frac{S^*}{\mu_r} + \frac{u^* + \alpha^2 \beta^{**} u^+}{(1 + \alpha^2 \beta^{**}) \mu_r}. \quad (28)$$

r^{BF} , r^{BFc} and r^{BM} indicate, for a given S^* , the level of r at the bliss point for the fiscal authority in the non-cooperative and in the cooperative case and for the monetary authority, respectively. The interest rate level depends on the value of the parameters appearing in the equation. For instance, *ceteris paribus*, it will be higher, the higher the unemployment target and its weight in the loss function.

In the non-cooperative case, the difference between r^{BM} and r^{BF} is:

$$r^{BM} - r^{BF} = \frac{\alpha^2(\beta^* - \beta^{**})}{(1 + \alpha^2 \beta^{**})(2\mu_s + \alpha^2 \beta^*) \mu_r} u^* - \left[\frac{\alpha^2(\beta^* - 2\mu_s \beta^{**})}{(1 + \alpha^2 \beta^{**})(2\mu_s + \alpha^2 \beta^*) \mu_r} \right] u^+, \quad (29)$$

a lower weight for unemployment for the central bank determining a higher difference between the two.

In the case of cooperative fiscal authorities, the difference $r^{BM} - r^{BFc}$ is equal to $\frac{\alpha^2(\beta^* - \beta^{**})}{(1 + \alpha^2\beta^{**})(1 + \alpha^2\beta^*)\mu_r} u^* - \frac{\alpha^2(\beta^* - \beta^{**})}{(1 + \alpha^2\beta^{**})(1 + \alpha^2\beta^*)\mu_r} u^+$; this is still positive, and its size with respect to the previous case depends upon the magnitude of μ_s : it is smaller than the difference $r^{BM} - r^{BF}$ if $\mu_s > 0,5$, while the bliss points coincide if $\mu_s = 0,5$. Recall that, given the assumption $(\mu_s + \nu_s) = 1$, this is equivalent to saying that the bliss points of the fiscal and monetary authorities are closer to each other in the cooperative case than in the non-cooperative one if $\mu_s > \nu_s$, while they coincide if $\mu_s = \nu_s$. However, without cooperation with the central bank, the cooperation between the fiscal authorities leads to a Nash equilibrium in the game played with the monetary authority implying a lower welfare level than that obtained when the fiscal authorities do not cooperate with each other. This situation is represented in Figure 2, that shows the reaction functions for the case $S^* = 0$ and for $\mu_s = \nu_s$.²²

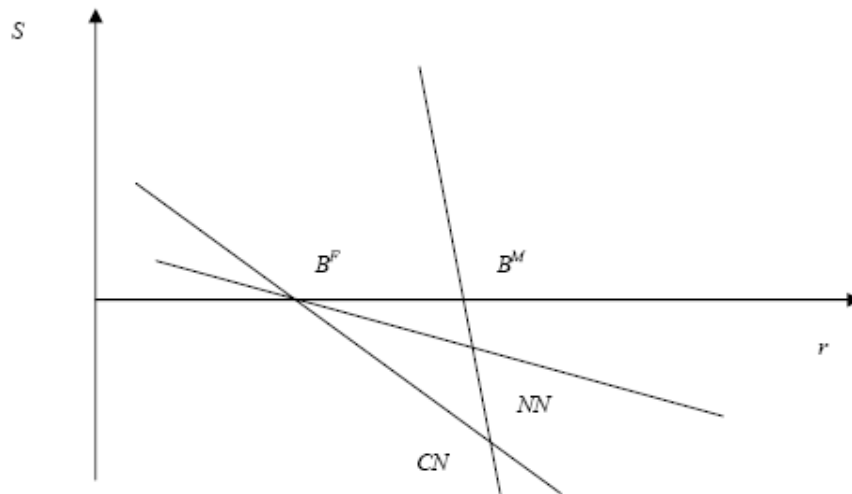


Figure 2. Nash equilibrium in the cooperative (CN) and non-cooperative (NN) case.

²² We keep considering the Nordhaus case in which the monetary authority is more concerned with price stability than employment; the opposite is true for the fiscal authority.

Given the coordinates of the bliss points for the fiscal and the monetary authority (B^F and B^M) and the slopes of their reaction functions, it is evident that the non-cooperative Nash equilibrium (NN) lies closer to the bliss points than the cooperative one (CN), the latter being characterized by a higher level of both the interest rate and the government deficit.

3.2.4. Discussion of the Results in the Case of Identical Countries

As shown, among others, by Nordhaus (1994) in a game between a fiscal and a monetary authority, the Stackelberg equilibrium with fiscal leadership is superior to the Nash one. The reason is that fiscal leadership leads to an outcome characterized by a less expansionary fiscal stance and a less restrictive monetary policy. As a matter of fact, when the fiscal and monetary authorities play a Nash game, they take the opponent's action as given while in the Stackelberg case the fiscal authority anticipates the reaction of the central bank, therefore moderating its fiscal expansion. As a result, the monetary authority will be able to follow a more expansionary monetary policy (see Figure 1). A corollary of this result is that economies characterized by an independent central bank, where the monetary and fiscal authorities play a Nash game, will normally face higher interest rates. As we have formally shown, if the two fiscal authorities do not cooperate with the central bank, it is preferable that they do not cooperate among themselves either. The explanation of such a conclusion lies in the fact that the externalities imposed by each country both on the other fiscal authority as well as on the monetary authority partially offset each other. As a matter of fact, if they do not cooperate, each fiscal authority does not take into account the positive effect of its action on the employment level of the other union member; the fiscal instrument, then, will be used less than optimally. At the same time, the negative effect on the central bank's objective function is also disregarded, which would yield too large a fiscal deficit. Being of opposite sign, the two external effects tend to offset each other. Instead, if the fiscal authorities do cooperate, a joint loss function is minimized, with the internalization of the effect of a fiscal action on the other country. As a result, each fiscal authority has a higher incentive to run a fiscal expansion, since it takes into account the beneficial effects on both itself and the other country. In technical terms, the fiscal authorities' reaction function becomes steeper and the Nash equilibrium implies a higher budget deficit. This higher budget deficit, however, implies a higher interest rate, since the monetary authority follows a more restrictive monetary stance in response to the more expansionary fiscal policy. Only a lack of cooperation between the two fiscal authorities, resulting in a lower fiscal expansion, would allow the central bank not to react (see Figure 2). The result that no cooperation at all is preferable to cooperation between some

players only is found in several papers on international policy coordination, starting from Rogoff (1985).

In line with the result obtained by Nordhaus (1994) in the closed economy, cooperation between the monetary authority and both fiscal authorities allows us to reach a point on the contract curve characterized by a more moderate fiscal policy (a higher fiscal surplus, S), and a more expansionary monetary policy (a lower interest rate, r), compared to the case above. This constitutes a rationale for the introduction of fiscal constraints in a monetary union, allowing us to interpret the Maastricht Treaty and the SGP in the light of our model.²³ We can translate their clauses into two elements: a) the central bank is obliged to pursue price stability, which can most easily be represented by a high value of β^{**} ; this induces a rightward shift of the monetary authority's reaction function, making the Nash equilibrium correspond to a higher r and a lower S (point NN' and CN' in the non-cooperative and in the cooperative case, respectively); b) a limit to the level of the deficit, as contemplated in the Maastricht Treaty and in the SGP, would allow the attainment of a position that is superior to the Nash equilibrium (point NN in Figure 3). The fiscal authority's reaction function would become horizontal when reaching it and the new equilibrium would be given by point M in Figure 3 (r would be higher if element a) is also taken into account - see point M'). Two polar cases would be as follows: i) the central bank chooses this limit at S^* ; ii) since the fiscal authorities might not be able to play Stackelberg for the reasons explained above (myopia and impatience), the limit is determined by an outside institution so as to reach such an equilibrium.

The scenarios sub a) and b) correspond to two alternative interpretations of the SGP. The first one is centred on the role of the ECB as the guardian of price stability, according to the clauses of the Maastricht Treaty. In this view, fiscal discipline reinforces the no bail-out clause which aims at reducing the risk of opportunistic behaviour by fiscal authorities. The problem with this interpretation is that it ends up with too restrictive a monetary policy.

Alternatively, the limits to government deficit and debt levels can be interpreted as a prerequisite for a more growth oriented monetary policy. Debt financed fiscal expansions aimed at supporting aggregate demand raise inflation and could trigger central bank interest rate increases and the resulting tighter monetary policy would hinder the possibility to expand employment. Conversely, binding fiscal rules would make it possible for the monetary authority to pursue

²³ A theoretical analysis of the SGP, based on the study of the interaction between many (myopic) fiscal authorities and a single monetary authority, is provided by Beetsma and Uhlig (1999).

growth oriented policies and, consequently, reduce the likelihood of having to pursue a more conservative policy stance.

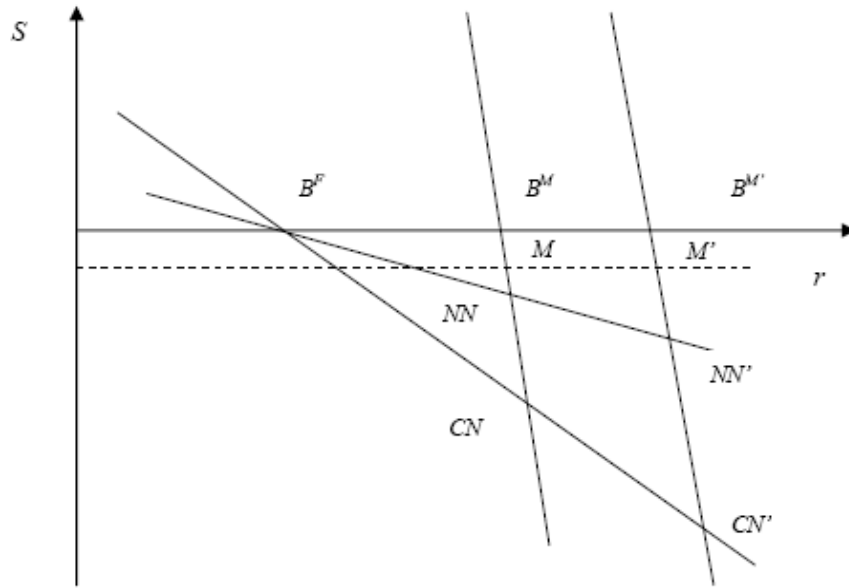


Figure 3. Effects of the Stability and Growth Pact.

The case for the imposition of fiscal rules is reinforced when considering a monetary union in which the fiscal authority of a small country interacts strategically with the monetary authority, as we show in the section below.

3.3. The Small Country Case

In the case considered above, a Stackelberg game with fiscal leadership would produce a more restrictive fiscal stance compared to the Nash game, since the fiscal authority optimizes by taking into account the monetary authority's reaction function rather than action. Such a result is proven, among others, by Nordhaus (1994), Dixit and Lambertini (2001), and generalized by Lambertini and Rovelli (2003).

When considering the behaviour of a small country, however, such a conclusion no longer applies. The reason is that the fiscal authority of the small country will face a vertical central bank reaction function, so that it will have no

incentives to follow a disciplined fiscal policy. It is well-known that such free-riding will occur (see, for example, Uhlig 2002), but we prove it here in an original way, namely by using a modified version of the Nordhaus model. By following the Nordhaus approach we show that such a conclusion emerges precisely when another well-established result no longer applies. As mentioned above, this occurs when the Stackelberg game with fiscal leadership produces the same result as the Nash game. The small country case situation can be analyzed within the two-country model presented above by imposing the following restrictions: $\delta \rightarrow 0$, $\varepsilon \rightarrow 1$ and $v_1 = 0$, implying that $\mu_l = 1$. These assumptions imply that the fiscal stance of the large country can be taken as given. The hypothesis can be justified in the limiting case of a country that is so small compared to the rest of the union that it cannot influence the unemployment rate of the whole area by using its instrument, so that the rest of the union will not react to changes in its fiscal position.

In order to obtain the Nash equilibrium in the game between the small country and the central bank, we need to determine the monetary and fiscal authorities' reaction functions. When $\pi^* = -\alpha u^+ + k$, the former is obtained by imposing the restrictions mentioned above to eq. (10), so that²⁴:

$$r = -\frac{\mu_2}{\mu_r} S_2 + \frac{u^* + \alpha^2 \beta^{**} u^+}{\mu_r (1 + \beta^{**} \alpha^2)}, \quad (30)$$

which indicates clearly that the monetary authority's reaction function does not depend on S_1 , i.e. it is vertical.

The latter is obtained by imposing the same restrictions to eq. (11), which results in:

$$S_1 = -\frac{v_2 S_2 - \mu_r r + \gamma_1^* S_1^* + u^*}{1 + \gamma_1^*}. \quad (31)$$

By applying the restrictions described above to eq. (12), we have the following expression for the reaction function of the large country (country 2)²⁵:

²⁴ The fiscal policy spillover parameter v_2 does not affect the monetary authority reaction function.

²⁵ The sign of v_2 affects the position, but not the slope of the fiscal authorities' reaction functions.

$$S_2 = -\mu_2 \frac{\mu_r (1 + \alpha^2 \beta_2^*)}{\mu_2^2 (1 + \alpha^2 \beta_2^*) + \gamma_2^*} r + \frac{\mu_2 (u^* + \alpha^2 \beta_2^* u^+) + \gamma_2^* S^*}{\mu_2^2 (1 + \alpha^2 \beta_2^*) + \gamma_2^*}. \quad (32)$$

By substituting it into the monetary authority reaction function, eq. (30), we obtain the value taken by r in the Nash equilibrium (r^N):

$$r^N = -\frac{\mu_2}{\mu_r} S^* - \frac{\mu_2^2}{\mu_r \gamma_2^*} \left\{ \left[\frac{\alpha^2 (\beta^{**} - \beta_2^*) - \gamma_2^* / \mu_2^2}{(1 + \alpha^2 \beta^{**})} \right] u^* + \left[\frac{\alpha^2 (\beta_2^* - \beta^{**}) - (\gamma_2^* / \mu_2^2) \alpha^2 \beta^{**}}{(1 + \alpha^2 \beta^{**})} \right] u^+ \right\}. \quad (33)$$

Symmetrically, by substituting eq. (30) into eq. (32), we get the value taken by S_2 in the Nash equilibrium (S_2^N):

$$S_2^N = S_2^* + \frac{\mu_2}{\gamma_2^*} \frac{\alpha^2 (\beta^{**} - \beta_2^*)}{(1 + \alpha^2 \beta^{**})} (u^* - u^+). \quad (34)$$

Finally, the Nash equilibrium value of S_1 (S_1^N), is obtained by replacing r^N and S_2^N into the small country's reaction function, so as to get:

$$S_1^N = \frac{\mu_2 - \nu_2 + \gamma_1^*}{(1 + \gamma_1^*)} S_1^* + \frac{(\mu_2 - \nu_2) \mu_2 \alpha^2 (\beta^{**} - \beta_2^*) + \alpha^2 \beta^{**} \gamma_2^*}{\gamma_2^* (1 + \gamma_1^*) (1 + \alpha^2 \beta^{**})} (u^* - u^+). \quad (35)$$

As for the Stackelberg equilibrium, the solution is found by minimizing eq. (7) with respect to S_1 subject to the restrictions for the small country case and to the constraint provided by eq. (33), which yields the same result as in the Nash case.

Figure 1 showed a negatively sloped monetary authority reaction function. In that case, moving from a Nash to a Stackelberg equilibrium allows for a Pareto improvement. Such a Pareto improvement does not occur, however, in the case that we are considering now. The intuition for this result is easily provided. The monetary authority would show no reaction to a fiscal consolidation undertaken by a small country. It would only react to a union-wide and coordinated fiscal restriction, capable to reduce both the inflation rate and the risk of financial instability. Thus, since each small country faces a very steep central bank reaction

function²⁶, it will not be able to move away from the Nash equilibrium by acting as a Stackelberg leader: the Nash and Stackelberg equilibria coincide, given that the indifference curve of the fiscal authority touches the vertical monetary authority's reaction function (Stackelberg equilibrium) precisely where the latter also meets the fiscal authority's reaction function (Nash equilibrium), as Figure 4 illustrates clearly.

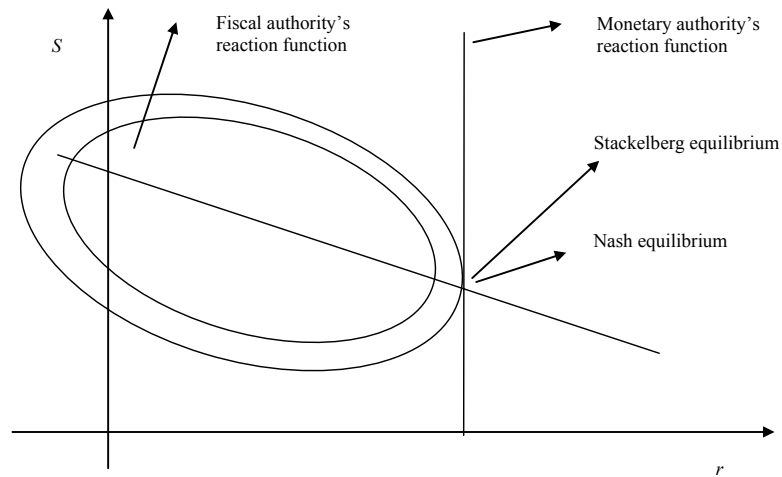


Figure 4. The Nash equilibrium and the Stackelberg equilibrium with fiscal leadership with a vertical central bank's reaction function (small country case).

3.3.1. Discussion of the Results in the Small Country Case

The two country case analyzed above, relative to the presence of a small and a large country, can be reinterpreted easily in order to consider the case of n small countries constituting a monetary union (where each of the n small countries plays against the set composed by the remaining $n-1$ ones). When playing the Stackelberg game with fiscal leadership, a small country will follow more disciplined behaviour compared to the Nash case, only if the same action is undertaken by the remaining $n-1$ countries (so that the monetary authority's reaction function reduces its negative slope, i.e. it becomes flatter). This would only be the case if the n small countries manage to *coordinate* their actions. In this situation the Stackelberg equilibrium will produce a more restrictive fiscal policy and a more expansionary monetary policy compared to the Nash equilibrium.

²⁶ For the political implications of the participation of small countries to EMU (Belgium and the Netherlands in particular) see Maes and Verdun (2005).

One can thus consider two different equilibria. The first one is characterized by the absence of coordination between the fiscal authorities of the n small countries and if they take the actions of their partners as given. This equilibrium also occurs if the small countries just believe that the partners will not modify their fiscal stance. The second equilibrium occurs when the fiscal authorities manage to coordinate their decisions – being aware of the fact that the central bank will only respond to a coordinated, and therefore generalized, fiscal consolidation.

As we have shown above, a non-cooperative equilibrium between two fiscal authorities is Pareto superior to a cooperative one when they do not cooperate with the monetary authority. It should be stressed, however, that while *cooperation* between two (and, a fortiori, more) fiscal authorities worsens the outcome, *coordination* among the n small fiscal authorities composing a monetary union would improve it²⁷, since their simultaneous decision to move in the same direction modifies the monetary authority's reaction function and induces its response.²⁸

In the absence of such coordination (which may be difficult to achieve), the fiscal rules introduced by the Maastricht Treaty and by the SGP are justified by the lack of incentive for each single fiscal authority to operate in a restrictive way. In particular, the imposition of those rules might make it common knowledge that everybody will behave in the same way, so as to eliminate the coordination problem. Rules operate, then, as a substitute for coordination. They prevent the risk that small fiscal authorities might become locked into their initial sub-optimal equilibrium and might not be able to coordinate on the Pareto superior one. This equilibrium, in turn, is characterized by fiscal restrictions in all countries accompanied by an expansionary monetary policy. In other words, in a monetary union composed of many small countries, each fiscal authority knows that its behaviour does not affect the choice of interest rate made by the central bank. Thus, this realization may produce a lack of fiscal consolidation. Or, to put it in more general terms, the larger the number of countries, the lower their incentive to reduce the fiscal deficit. If the fiscal authorities of small countries manage to coordinate their actions, however, they can reach a result which is similar to the

²⁷ Note that fiscal coordination among European countries is strongly advocated in the Maastricht Treaty.

²⁸ The difference between coordination and cooperation is rather subtle and far from univocally accepted (see, for example, Mooslechner and Schuerz 2001). In this paper we refer to cooperation between two players when they optimize a weighted average of their opponent's and of their own utility functions. We refer to coordination when, in presence of multiple equilibria, two players that might end up in the sub-optimal one manage to move to the Pareto superior outcome.

one generally obtained within a country, where a single fiscal authority faces a single central bank.

Having just explained the small country case, one could posit that some larger countries also fail to pursue fiscal discipline.²⁹ The reason for such a phenomenon is that in reality fiscal rules apply asymmetrically to European countries: while small countries may perceive these rules as effective and binding, large countries, because of their greater voting power, may substantially ignore them. Such a situation can be represented in our model by letting γ_1^* , the parameter expressing the cost of fiscal convergence from a given target, tend to infinity for small countries, while letting it be very low for large ones.³⁰

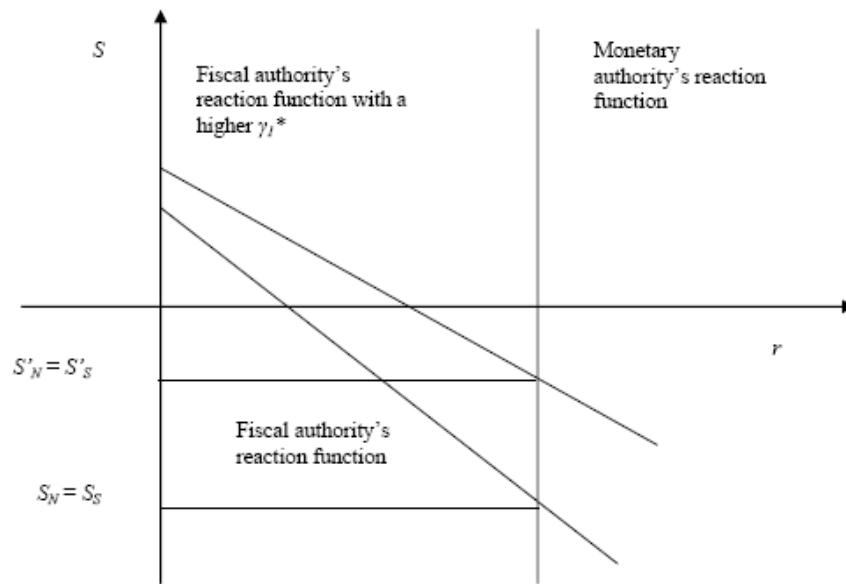


Figure 5. The effects of increasing the cost of the deviation from the fiscal target: both the Nash and the Stackelberg equilibrium are characterized by a lower fiscal expansion.

It is easy to verify that by increasing the credibility of the fiscal rules (i.e. by increasing the cost of divergence from the fiscal target), a reduction in fiscal expansion occurs, since the fiscal authority's reaction function moves upwards

²⁹ For the complete list of the countries subject to the Excessive Deficit Procedure (EDP) established with the SGP, see the European Council website: (http://ec.europa.eu/economy_finance/about/activities/sgp/main_en.htm).

³⁰ Schure and Verdun (2007) (in this issue) model this behaviour in more detail.

and reduces its negative slope (see eq. (31)). The effects of a higher γ_I^* can be verified graphically, as shown in Figure 5 above. It is also worth observing that while in the case of identical countries less fiscal expansion occurs either by moving to a Stackelberg game or by imposing tighter fiscal targets (S^*), the cost of deviation from the target (γ^*) being irrelevant, in the small country case such cost affects crucially the final outcome.

4. CONCLUDING REMARKS

A standard result in the literature on monetary and fiscal policy coordination is that a Nash game played between a monetary and a fiscal authority leads to excessive deficit spending and high interest rates. Considering the case of a monetary union composed of two identical countries, we show that when the two fiscal authorities do not cooperate with the central bank, the same inefficient result occurs even if the fiscal authorities cooperate with each other. In fact, in the absence of cooperation with the central bank, a better outcome is attained when there is no cooperation between the two treasuries. When this is not the case, the introduction of fiscal rules, such as those contained in the Maastricht Treaty and in the SGP, is justified. Such rules can be welfare improving because lower deficit/higher surpluses allow the central bank to follow a more expansionary monetary policy. In other words, fiscal requirements are a pre-condition for a growth oriented monetary policy.

Another reason for enhancing fiscal rules arises when considering the presence of small countries. While in the game played by a fiscal authority and a monetary authority a Stackelberg game with fiscal leadership allows us to reach an outcome that Pareto dominates the Nash one, we show that, when the Stackelberg game is played by a small country, such a game collapses to the Nash case since the monetary authority's reaction function becomes vertical. The monetary authority will only respond to the fiscal authority of the small country if the latter manages to coordinate its action with the fiscal authorities of the remaining $n-1$ countries. In such a situation fiscal consolidation undertaken by a single country would become generalized, so as to allow a positive central bank response: while cooperation between two or more fiscal authorities may be welfare reducing, coordination among many small fiscal authorities may be welfare increasing.

The result obtained by Van Aarle et al. (1997), mentioned in section 2, is similar to our own, in that the central bank does not react to a fiscal adjustment undertaken by a single fiscal authority, since such a limited adjustment is not

enough to reduce the union's aggregate demand and inflation rate. They conclude that, when the number of players in EMU increases, the strategic power of the central bank also increases. In the small country case of our modified Nordhaus model we provide a different interpretation and show that an increase in the number of fiscal players reduces the incentives for fiscal discipline, so as to produce the well-known result of fiscal authorities free-riding in a monetary union. We also show that free-riding emerges when another well-known result, namely the Pareto superiority of a Stackelberg game with fiscal leadership with respect to a Nash game, fails to be valid.

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THE ART AND CRAFT OF BUDGETING: FISCAL POLICY IN THE EUROZONE

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ABSTRACT

In the past twenty-five years we have seen a growing body of literature on the determinants of fiscal policy as measured by analyzing cross-national data on budgetary deficits and public debts. The discussion is largely shaped by Jürgen von Hagen's work on the impact of both political and economic institutions. In this paper we will take a slightly different angle, looking at cultural variables. Taking Aaron Wildavsky's cultural theory of budgeting as point of departure, we assume that the budgetary strategy of the countries in the eurozone is related to their political culture or regime. Using empirical data provided by the European Union, we conclude that empirical support for the cultural theory of budgeting is concentrated at the extremes of the political spectrum. However, empirical support is much stronger if we differentiate to the economic situation. The outcome underscores, once again, that it is hard to maintain an anti-cyclical policy during an upswing of the economy.

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1. INTRODUCTION

In the early 1990s the heads of state and government of the European member states gathered in the southern part of the Netherlands. The Maastricht Treaty not only established the European Union (EU), but also set the criteria for the qualification and participation in Economic and Monetary Union (EMU). In this paper I will focus on the budgetary criteria and procedures for the reduction of the budget deficit. The reason is twofold. The budget deficit has played a leading role in the decision about qualification for and participation in EMU and has continued to play a role afterwards, whereas inflation and interest rates have lost relevance with the arrival of the common monetary policy (Italianer 1993: 17).

The reference value for the budget deficit was originally set at three per cent of Gross Domestic Product (GDP) at market prices, as deducted from the target for the public debt (Bini-Smaghi 1994: 30 fn.; Lubbers 1996)², though the relation has not played a decisive role in the choice of the reference values (Szász 1999: 159-160). It was later reinforced when the heads of state and government of the European member states committed themselves to reduce the budget deficit even further and to a medium term budgetary position of ‘... close to balance or in surplus’.³

The research question addressed in this paper is what constraints on the fiscal policy of European member states are induced by the new institutions of EMU? In particular, the paper examines the procedure for the reduction of excessive budget deficits. Taking Aaron Wildavsky’s *Cultural Theory of Budgeting* as point of departure, the paper explores the budgetary strategies of European Member States. It concentrates on the ‘policy mix’ that governments of the ‘old’ European member states have put together to meet the reference value of the budget deficit. The empirical data are mainly taken from the group of countries that were already part of the EU prior to the most recent enlargement towards Central and Eastern Europe, the so-called ‘EU-15’, that took place in 2004. In particular, it focuses on those countries that have already adopted the euro, often referred to as the ‘EU-12’ or the eurozone.

The article is structured as follows. In section 2 a non-comprehensive survey is given of the literature on fiscal policy, notably the impact of budgetary institutions on the size of the budget and the budget deficit. The essentials of Wildavsky’s cultural theory of budgeting are presented in section 3, arguing that

² The public debt remains constant at a nominal growth of GDP of five per cent and a budgetary deficit of three per cent.

³ Note that the heads of state and government committed themselves to a balanced budget before the decision about the qualification for and participation in EMU was made.

the budgetary strategy (dependent variable) is directed by the political culture or regime (independent variable). In section 4 a description is given of the institutional framework, which articulates the point that having a common monetary policy requires fiscal coordination. Wildavky's cultural theory of budgeting presented in section 3 is put to a test in section 5. The test consists of combining statistical data, provided by Geert Hofstede for the political culture and by the European Commission with Eurostat for the budget deficit, notably the structural balance. Although we find some evidence, support for Wildavky's cultural theory of budgeting is rather weak.

2. FISCAL POLICY

In the past twenty-five years we have seen a growing body of literature on political and economic variables of fiscal or budgetary policy as measured by analyzing cross-national data on budgetary deficits and public debts.⁴ Using Barro's 'tax smoothing' model as a benchmark, Alesina and Perotti (1995a) distinguish six political economic models for the analysis of budget deficits, at the heart of which are concepts such as 'fiscal illusion' and 'spending bias'. Wildavky's cultural theory of budgeting, used in this paper as a conceptual lens, is most related to the models that emphasize the effects of institutions (Zijderfeld 1998).

The literature on institutions may be further refined by making a distinction between two complementing subsets: 'electoral institutionalism' and 'fiscal institutionalism' (Hallerberg 2004: 9; Hallerberg and Von Hagen 1999: 210-211). The former looks at the impact of the electoral system, arguing that pluralist systems in which the winner takes all is doing better in terms of fiscal consolidation than systems with proportional representation which are typically characterized by coalition cabinets. The latter looks at the impact of budgetary institutions on the size of the budget. Borrowing from Alesina and Perotti (1995a: 21), budgetary institutions are defined here as all rules and regulations that influence the preparation, authorization and implementation of the budget.

The discussion about the impact of budgetary institutions on the outcome of fiscal policy is largely shaped by Jürgen von Hagen's work for the European

⁴ Not surprisingly, the publication of Barro's article coincided with the consequences of the oil crises. In recent years we have seen a shift from the countries who are a member of the Organisation for Economic Cooperation and Development (OECD) to the European Member States. This shift, due to the establishment of EMU and the Stability and Growth Pact, has created a fertile breeding ground for cross-national comparisons.

Commission (Von Hagen 1992; Von Hagen and Harden 1994), testing two hypotheses.

1. The *structural* hypothesis: fiscal discipline is promoted by a strong prerogative of the prime minister or finance minister vis-à-vis the spending ministers, the limitation of amendments by parliament and a strict execution of the budget;
2. The *long-term constraint* hypothesis: the more budgetary decisions are tied to a multi-annual fiscal program, the greater the degree of fiscal stability.

Von Hagen (1992: 5) found support for the first, but not for the second. The relation between long-term fiscal constraints and fiscal discipline, while in most cases positive, was not significant (Von Hagen 1992: 54). For that reason, a coalition would not be able to carry out successful fiscal adjustments (Alesina and Perotti 1995b: 208). In addition they note that coalitions do not cause budget deficits per se, but coalitions delay fiscal adjustments (Alesina and Perotti 1999: 33).

In subsequent work Hallerberg and Von Hagen (1999: 216) concluded that delegation to a strong treasurer is more appropriate for a political party with a single party in office, whereas commitments to fiscal targets fit coalitions better. A reassessment by De Haan et al. confirms that budgetary institutions affect the outcome of fiscal policy, but the effect is quite small (De Haan, Moessen and Volkerink 1999: 284). However, we should be careful with the interpretation of these findings as they are based on the construction of indices and do not take into account the relative weight of the building blocks (Poterba and Von Hagen 1999: 4).

In this paper we will take a slightly different angle. First, we assume that the budgetary strategy of the EU-15, notably the EU-12, is influenced by their respective political culture. In so doing, we expect that the effectiveness of budgetary institutions in reducing the

deficit bias depends on the general political setting of a country (Poterba and Von Hagen 1999: 12). Following Wildavsky, for each country a political culture is made up by a combination of two variables, i.e. the number of prescriptions ('grid') and the degree of individualism as opposed to collectivism ('group strength').⁵ Second, we focus on the budgetary deficit (or to be more precise the

⁵ A culture is, as such, a broader concept than an institution as it is referring to rules and regulations as well as beliefs, norms, traditions and values.

structural balance, excluding interest payments) rather than the accumulation of the debt. The reason for making this choice is that our main purpose is to test Wildavsky's cultural theory of budgeting instead of providing an explanation of the budgetary strategy or fiscal policy of individual European member states. In their analysis of the budget deficit in the OECD-countries Roubini and Sachs (1989b) conclude that the size of the budget deficit is related to political as well as economic characteristics of countries:

'Budget reduction requires political consensus, at least among the members of government. We noted that such a consensus was harder to achieve in multi-party coalition governments' (Roubini and Sachs 1989b: 126).

Third, we look at the size as well as at the composition of the budget deficit, which is often neglected in the literature on fiscal policy (Alesina and Perotti 1995b: 208; Alesina and Perotti 1999: 21). In their work on the budgetary deficit in OECD-countries they find that there are almost no changes in the rate of taxation in years of economic expansion and, if any, that mainly transfers and wages in the public sector increase during an upswing of the economy. In addition, they find that there are virtually no changes in spending in years of economic contraction and that public investment suffers most during a downturn of the economy. A successful adjustment of a budgetary deficit, 'does not raise taxes, but, rather, cuts transfer programmes and government wages and employment' (Alesina and Perotti 1995: 240-241).

The data taken from the Annual Macro-Economic Database (AMECO) provided by the Directorate-General on Economic and Financial Affairs (DG ECFIN, formerly known as DG II) were updated on December 1, 2005. Contrary to the budgetary criteria used in EMU, the Stability and Growth Pact (SGP) and the Excessive Deficit Procedure (EDP) we focus on the adjusted primary deficit or the *structural* balance instead of net borrowing (+) or net lending (-) as percentage of GDP at market prices for the same reasons as Buti et al. did in their analysis of the budgetary policies during recessions. The adjustment for the cycle does not cover all the changes in the environment such as fluctuations in inflation and interest rates. Taking interest payments out provides a rough indication of how a government is pursuing a budgetary strategy towards fiscal consolidation (Buti, Franco and Ongena 1997: 7).

The analysis covers two periods of six years each. The first period, focused on the budgetary convergence, starts in 1993 assuming that the Member States anticipated the ratification of the Treaty of the European Union (TEU) later that year and ends with the decision about the qualification for EMU in 1998. The

second period is marked by the SGP that had been established a year before at the Amsterdam Summit (1997) and geared to fiscal stability. It ends with the decision of the Council of Ministers of Economic and Financial Affairs (ECOFIN) in November 2003 to suspend the EDP in the case of France and Germany, notably not to move to the next steps of the EDP (which would have brought the pecuniary sanctions closer). Additionally, some information is provided for the third period that starts in 2003.

3. A CULTURAL THEORY OF BUDGETING

The appeal of Valdimer Key for a budgetary theory denotes the interest in public budgeting in the contemporary period. He clearly referred to a *normative* theory, raising the question: ‘on what basis shall it be decided to allocate X dollars to activity A instead of activity B?’ (Key, quoted in Hyde and Shafritz 1978: 20). Efforts to develop such a theory failed until Aaron Wildavsky took the baton. The first edition of his seminal *The Politics of the Budgetary Process* changed the budgetary landscape. He argued that the allocation of scarce resources is not a matter of arithmetic or calculation, but a matter of power. Budgeting is politics.

In the mid 1980s Aaron Wildavsky, influenced by Mary Douglas’ work, turned to culture as the main explanation for the way in which a government will respond to a situation of fiscal stress (Caiden 1995: 49), arguing that political culture or regime can be assessed and classified into two categories:

1. Grid, referring to the number of prescriptions or rules that constrain discretionary behaviour of individuals and/or organizations.
2. Group strength, referring to the customary distinction between individualism and collectivism.

The combination of these two categories leads to four logical positions or in Aaron Wildavsky’s words ‘primary colors’.

Prescriptions \ Group Strength	Weak	Strong
	Many	F
Few	M	E

Source: Wildavsky (1986).

Figure 1. A Classification of Political Cultures or Regimes.

The main hypothesis of Wildavsky's cultural theory of budgeting is that the government of each political culture or regime (as independent variable) will pursue its own budgetary strategy (as dependent variable), being shaped by the degree of control over revenues and expenditures:

1. A hierarchy (H), also referred to as collectivism, can manage revenues, but not expenditures because of the many echelons between the top to the bottom where the spending takes place;
2. A sect that is driven by egalitarianism (E) can control expenditures, but cannot manage revenues because it lacks the internal authority to make large demands on the members;
3. A fatalistic system (F), being subordinate, can manage neither expenditures nor revenues and, therefore, suffers from apathy. Consequently, the government will 'do nothing';
4. A market (M), characterized by individualism can manage both revenues and expenditures (at low levels). The state is kept poor by making only resources available for collective goods leading to reduction of both revenues and expenditures.

In reality, there are all kinds of alliances or hybrids.⁶ The combination of a hierarchy and the market is so common that Aaron Wildavsky calls this political regime the *establishment* (E).⁷ Political cultures disagree on the ideal size of

⁶ Apathetic regimes (fatalism) are often excluded at the institutional level (Mamadouh 1997: 21) and, therefore, left out as well as the combination of apathetic regime with one of the other regimes (authoritarianism and totalitarianism).

⁷ He does not provide a label for the other diagonal, i.e. a combination between an egalitarian and fatalistic regime, probably because such a hybrid is not viable.

government, while a hierarchy prefers a large and the market a small government. The compromise will be a medium level of taxing and spending. A mix of a hierarchy and an egalitarian regime is called a *social democracy* which is supposed to pursue a strategy that consists of an increase of both revenues and expenditures. He argues that all Western democracies are pluralists (P) being a combination of a hierarchy, the markets and a sect (see triangle in figure 1).⁸ Consequently, the budgetary strategy will vary depending on the respective strength of each culture. The stronger the hierarchical element, the more both revenue and expenditure go up. The stronger the market forces, the lower the taxing and spending and the stronger the sectarian regime, the higher the spending and the lower the taxation. Strangely, the combination of raising taxes and spending cuts is not mentioned by Wildavsky, though it seems to be the most adequate strategy to reduce a budget deficit.

A couple of comments should be made. First, it is hard to classify the political culture or regime of the EU-15 since the dimensions are not operational in spite of Aaron Wildavsky's assertion to the contrary (Wildavsky 1986: 336-337). A useful alternative is provided by the dataset that Geert Hofstede has put together to 'measure' the impact of culture in forty countries, using four and later five indicators (Annex I and II). The uncertainty avoidance index (UAI) focuses on the level of tolerance for ambiguity and uncertainty within a society. A high score indicates a rule-oriented society that institutes laws, rules, regulations, and controls in order to reduce the amount of uncertainty and is matching, as such, the number of prescriptions to maintain the status quo. The inverse of the indicator Individualism (IDV) may be used as a proxy for group strength as a low score typifies societies of a more collectivist nature with close ties between individuals.

A scatter diagram, using the dataset provided by Geert Hofstede's on his website, shows that the EU-15 might be positioned along the diagonal between a hierarchy (upper right corner) and a market (lower left corner), reflecting the establishment.

⁸ A pluralistic regime should not be confused with the so-called 'hermit' i.e. a person who is deliberately withdrawing from social involvement (Mamadouh 1997: 19).

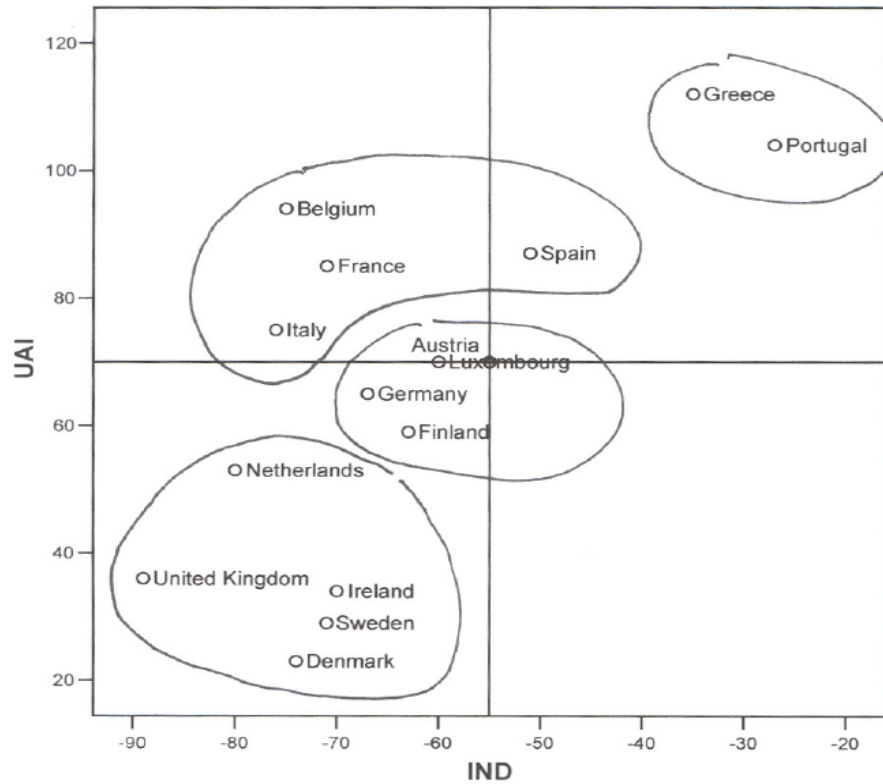


Figure 2. A Classification of the Political Culture of the EU-15.

The correlation between the two dimensions is significant at the 0.01 level, i.e. the number of prescriptions (UAI) goes along with group strength (IND). In addition, one may argue that a political culture is not bi-dimensional, but multi-dimensional. A dendrogram (see Annex III) shows that the EU-15 should be clustered into roughly three groups, one being divided in two subsets, roughly matching Loughlin and Peters' classification of state traditions described as 'sets of institutions and cultural practices that constitute a set of expectations about behaviour (Loughlin and Peters 1997: 45-48):⁹

⁹ A classification on the basis of a distinction between, on the one hand, a unitary state vs. a federation and, on the other hand, the level of centralization/decentralization is provided by Arend Lijphart in his work on democracies (Lijphart 1984; 1999; Van Auel and Van Nispen 2002).

- Cluster I: Greece and Portugal
- Cluster IIa: Belgium, France, Italy and Spain
- Cluster IIb: Austria, Finland, Germany and Luxembourg
- Cluster III: Denmark, Ireland, The Netherlands, Sweden and the UK

On the basis of Wildavky's cultural theory of budgeting we assume that all European member states have put together a 'policy mix' of measures of both revenues and expenditures in order to meet the reference value for the budget deficit (net borrowing/lending) which is set at three per cent of GDP at market prices. They have basically three choices to reduce a budget deficit and to balance the budget.¹⁰

1. The introduction of new taxes and/or an increase of existing rates to enable a high level of spending;
2. A reduction of expenditures, for instance by the postponement of investments and/or spending cuts;
3. The promotion of economic growth as the budget deficit will disappear when the economy expands.

In this paper we focus on the first two options as is illustrated in figure 3. In line with Roubini and Sachs' analysis of government spending and budget deficits in the OECD-countries we do not attempt to explain government investment (Roubini and Sachs 1989: 111). The outcome will be a combination of revenues and expenditures as all European member states can be considered pluralistic regimes.

Taking the diagonal from lower left corner to the upper right corner of the scatter diagram as a regression line, we assume that the countries in cluster I (hierarchy) focused on an increase of revenues, though mitigated by an increase of expenditures. Besides, we expect that the countries in cluster II (establishment) raised taxes and cut back on spending with group A having a preference for an increase of revenues and group B for a decrease of expenditures. Finally, we suppose that the countries in cluster III (market) had a preference for a decrease of expenditures inducing a decrease in revenues.

¹⁰ In addition, the member states that do not participate in the third stage of EMU – Denmark, Sweden and the UK – may pursue their own monetary policy, manipulating the internal as well as the external value of their currency. In practice they follow the common monetary policy of the EU-12.

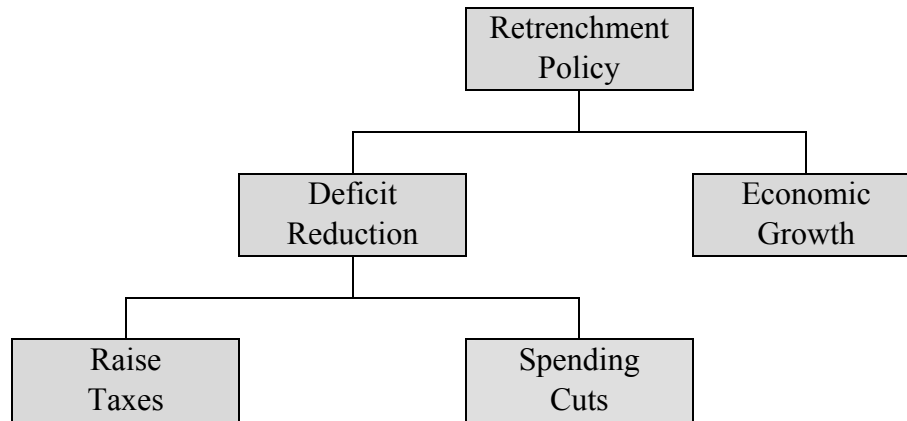


Figure 3. Analytical Framework.

4. THE INSTITUTIONAL FRAMEWORK

The treaty of Maastricht creating the European Union established a number of new institutions, foremost the criteria for the qualification for and participation in Economic and Monetary Union (EMU) later followed the Stability and Growth Pact (SGP) that, among other things, speed up and clarified the Excessive Deficit Procedure (EDP) already contained in the Maastricht treaty. Consequently, the European member states are not completely free to pursue their own budgetary strategy as they are subject to benchmarking, coordination and monitoring or surveillance under the before-mentioned agreements.

The budgetary policy of the European member states is more or less directed by the reference value of the budget deficit that was agreed upon at the Maastricht summit (1991).¹¹ The rules prohibit a budget deficit exceeding 3 per cent of GDP at market prices (except under exceptional and temporary circumstances). The reference value for the budget deficit was set at 3 per cent of GDP at market prices. The Amsterdam summit (1997) reinforced and strengthened this commitment when the heads of state dedicated themselves to a budgetary position close to balance or in surplus.¹²

The governments of the European member states are still in charge of the composition of the 'policy mix' to keep the budget deficit as well as the public

¹¹ The budgetary policy is further directed by the reference value for the public debt that is set at 60 per cent of GDP at market prices.

¹² The reference values are put in a protocol and are, therefore, easier to change than the treaty.

debt below their reference value. However, they have to submit a convergence or stability report every year that, inter alia, assesses the state of the economy and the measures that they have been taken to keep the budget deficit and public debt below the reference value.¹³ An early warning, (to use a soccer analogy) the so-called ‘yellow card’ – is issued when the budget deficit comes close to the reference value. In case of a break of the reference value the EDP might come into operation – the so-called ‘red card’ – but that requires a decision by the ECOFIN that a European member state is in derogation.¹⁴

Finally, the budgetary policy is subject to coordination through the Broad Economic Policy Guidelines (BEPGs) that may be seen as a form of open coordination ‘avant la lettre’. A major difference with the EDP is that these are only political ‘commitments’ that cannot be legally enforced. The link between budgetary and economic coordination is recently reinforced by the decision to integrate the Broad Economic Policy Guidelines and the Employment Guidelines as the centrepiece of the relaunch of the Lisbon Strategy.

The authority of the European Union to coordinate the budgetary policy has been challenged by the French minister of Finance, Francis Mer, claiming that the responsibility for the fiscal policy belongs to the exclusive domain of individual European member states:

‘Nous sommes encore dans une Europe où la politique budgétaire et la politique tout court d’un Etat restent sous son contrôle.’ (Mer 2002).

He refused, supported by his German colleague, to reduce his budget deficit below the reference value. Motivated by electoral reasons, he issued a package of measures to accomplish tax relief instead of deficit reduction, arguing that the SGP is not alone about stability but also about growth. The argument he made was that the budgetary deficit would disappear as the economy recovers. Unfortunately, the outcome of this strategy will be only visible in the long run.

The decision of the ECOFIN has been brought before the European Court of Justice by the former commissioner for Economic and Financial Affairs, Pedro

¹³ The main difference is in the monetary policy. The European member states that do not participate in (final stage of) EMU pursue their own monetary policy and, therefore, should provide information about inflation and interest rates in addition to the state of the budget. The participants in EMU have to provide information only about the state of the budget since the (common) monetary policy is left in the hand of the European Central Bank (ECB) that is located in Frankfurt, Germany.

¹⁴ A qualified majority is needed of all votes including the European member state in derogation. It allows ECOFIN to make recommendations. In the end, the procedure may lead to financial sanctions against those who fail to comply. The decision is made by a two-third majority of the votes whereby the European member state in derogation is left out.

Solbes Mira, backed unofficially by the Dutch government. The court has ruled that the decision of the ECOFIN is illegal and, therefore, it has to reconsider its position, implicitly underscoring that there is no distinction between big and small states. The outcome of this case has changed the intended meaning of the original agreements. The reference value of the budget deficit is saved, but the damage is unmistakably done. A more flexible interpretation of the EDP is the outcome or the price that has been paid for this rescue operation. The ministers of finance could take into account the local economic situation, notably economic cycle and the size of the public debt. In addition, coherence is required between the budgetary and economic policy objectives as part of the Lisbon Strategy. As compensation, the European member state should pursue a more restrictive budgetary or fiscal policy in time of economic growth. The alternative is to adjust net lending or net borrowing for the cycle and to look at the *structural* balance, taking the so-called ‘output gap’ into account.¹⁵

5. FISCAL COORDINATION

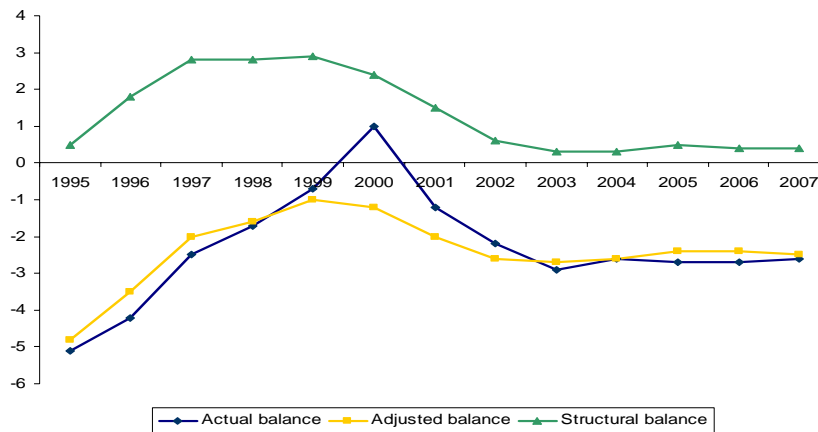
In the spring of 1998 ECOFIN met in Brussels to decide on the starting date of EMU that had been reinforced and strengthened just before at the Amsterdam summit. All but one, notably Greece, passed the test, though it later became clear that the then government had manipulated the statistics. Only three out of fifteen EMU member states stayed out of the third stage of EMU and, therefore, the single currency.¹⁶ However, it should be noted that many did not meet the reference value for the public debt. With a public debt of more than 100 per cent of GDP, some countries like Belgium, Greece and Italy were far from close to meeting the reference value for public debt. The price for economic stability, i.e. the risk of political instability, turned out to be too high.

The development of the *actual* balance shows the budgetary position is first underestimated (1995-1998), later overestimated (1998-2003) and seems to stabilize from 2003 onwards, though close to the reference value (Annex IV). The average deficit of the EU-15 was even turned into a surplus for a short period at the beginning of the millennium, but that is partly due to the countries that for various reasons do not participate in EMU (Denmark, Sweden and the United

¹⁵ The output gap is the difference between the actual and potential growth of the economy. We would like to note that there is no agreement among experts about the calculation of the output-gap, because it is not clear what constitutes the potential growth of the economy. The structural balance should be treated therefore with prudence.

¹⁶ Greece became part of EMU on 1 January 2001.

Kingdom). The findings suggest that fiscal coordination through the SGP and the EDP has been successful, also taking into consideration the time lag needed for implementation. In addition, the impact of the cycle seems to have diminished indicating that the budget situation is more or less under control. Besides, the structural deficit is moving in the same direction though in surplus.

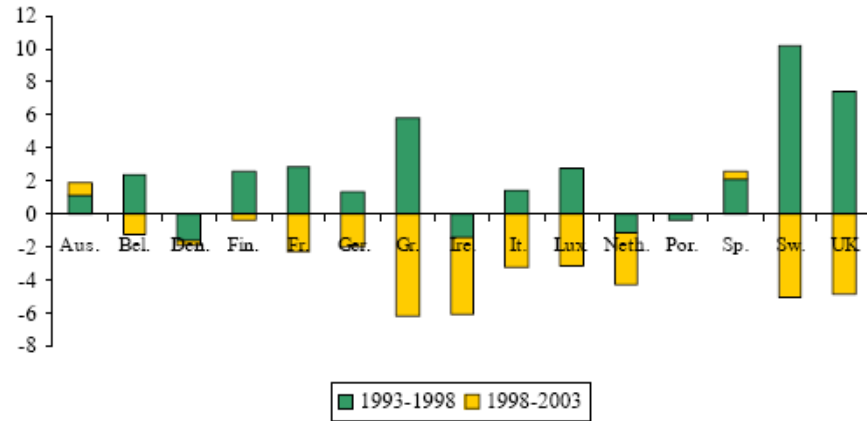


Source: European Commission (2006). The data for FY 1993 and FY 1994 are not available.

Figure 4. Budgetary Performance EU-15 (FY 1995-2007).

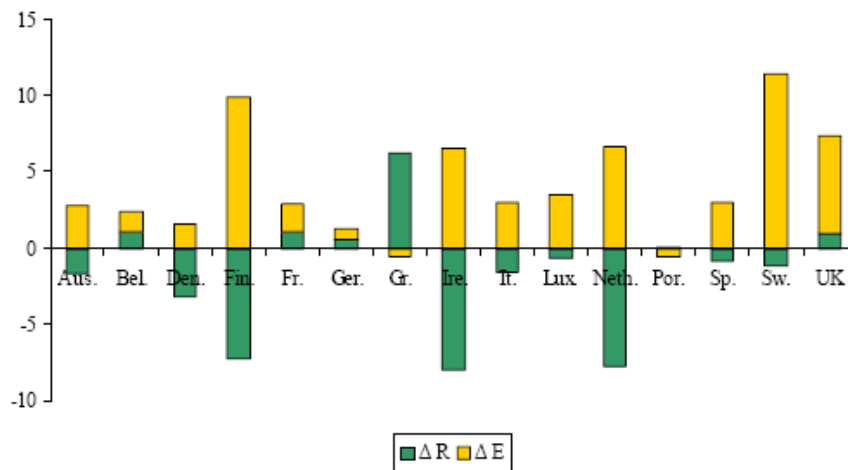
At first value the structural balance of the EU-15 worsened over time (0.2 per cent), but a closer look reveals that the structural balance improved in the first period and worsened in the second period, when most countries featured an upswing in their economy (Annex V). A breakdown per country for both periods shows a wide variety, diverging from 5.2 per cent in the case of Sweden to -6.1 per cent for Ireland over the entire period (Annex VI).

The fiscal coordination in the first period was focused on budgetary convergence, reducing the *actual* balance below the reference value. The *structural* balance improved in 9 of the EU-12 (11 of the EU-15) with Sweden as the front-runner (10.2 per cent) and the UK as the runner-up (7.4 per cent), followed by Greece (5.8 per cent).



Source: European Commission (2006).

Figure 5. The Development of the Structural Balance of the EU-15 (FY 1993-2003).



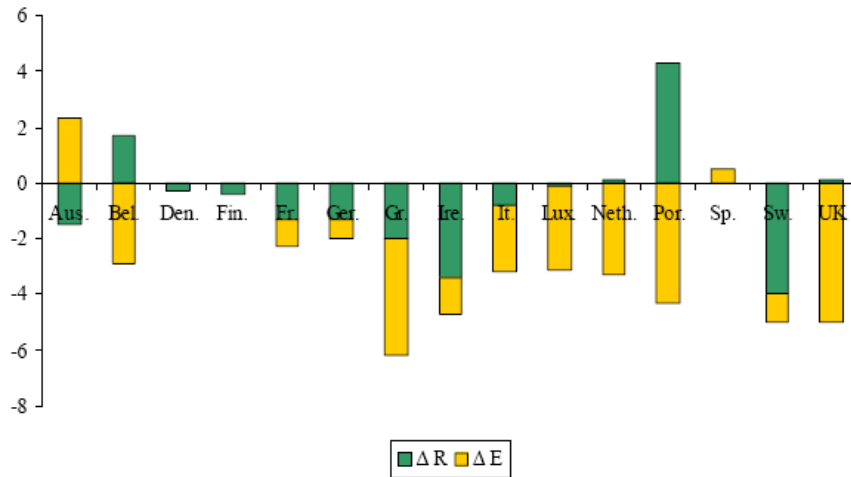
Note: A positive sign indicates a decrease, a negative sign an increase of the deficit.

Source: European Commission (2006).

Figure 6. The Composition of the Structural Balance, FY 1993-1998.

The adjustment of the structural balance in the first period is mainly due to a decrease of expenditures. By increasing revenues and expenditures, Greece and Portugal were the exception. Note that spending cuts in four countries – the big countries plus Belgium – were supported by an increase of revenues and in nine countries they were mitigated by a decrease of revenues.

The gains in the first period were completely ‘reversed’ in the second period which can be characterized by a combination of tax relief and extra spending, thus creating a budget deficit rather than a budget surplus. In sum, the structural balance worsened in nine countries of the EU-12 with Greece in the worst position (6.2 per cent). In one country – Portugal – the increase of revenues compensated for the increase of expenditures and in two countries – Austria and Spain – we see a modest improvement of the structural balance. The dominant path taken by most governments was an increase of expenditures, fuelled by a decrease of revenues. However, expenditures were kept at the same level in two countries – Denmark and Finland – whereas the empirical data for two other countries – Austria and Spain – reveal a decrease of expenditures.



Note: A positive sign indicates a decrease; a negative sign indicates an increase of the deficit.

Source: European Commission (2006).

Figure 7. The Composition of the Structural Balance, FY 1998-2003.

Looking at the budgetary strategy reveals that Wildavky’s cultural theory of budgeting better accounts for the situation in the first period than in the second period (Annex VII). A closer inspection of the first period shows that Wildavky’s cultural theory of budgeting is doing relatively well for cluster I as both Greece and Portugal increased both revenues and expenditures with the increase of revenues exceeded by the increase of expenditures. The empirical data for cluster II do not support the assumption of Wildavky’s cultural theory of budgeting as all but Belgium issued tax relief in combination with spending cuts, whereas

Germany kept its expenditures at the same level. The evidence points to a path that is leading via extra spending for investments (in order to stimulate economic growth and employment) to a reduction of the budget deficit (increasing the nominator of the deficit/GDP-ratio). The findings for cluster III are more or less in line with the assumption of Wildavsky's cultural theory of budgeting with the clear exception being the UK who increased rather than decreased revenues.

In the second period we only found evidence for Portugal who increased both revenues and expenditures, counterbalancing each other with the outcome being null. The number of hits is increasing substantially if we adopt an additional hypothesis and take the economic situation into account. The second period features an economic upswing, taking the pressure off the reduction of the budget deficit. The dominant strategy is exactly the opposite of the hypothesis deduced from Wildavsky's cultural theory of budgeting, i.e. a mix of tax relief and additional spending, once again underscoring that it is harder to pursue an anti-cyclical policy during an upswing than a downturn of the economy.¹⁷

6. CONCLUSION

In this paper we have applied Aaron Wildavsky's cultural theory of budgeting to the EU-15. We have found some evidence supporting the theory, but mainly at the extremes of the political spectrum. A breakdown per cycle provides some additional evidence for the cluster in the middle of the political spectrum (cluster II), but the evidence is rather weak. We have found a match for only three of the eight countries in that group (Belgium, France and Germany) pursuing a budgetary strategy composed of an increase of revenues and a decrease of expenditures. The remaining five countries in that group pursued a budgetary strategy that is associated with the market, making the combination of tax relief and spending cuts the dominant budgetary strategy in the first period. A mix of tax relief and extra spending characterizes the main budgetary strategy in the second period and was geared more towards fiscal consolidation. Consequently, both actual and structural deficit balances declined in all but three countries (Austria, Portugal and Spain). Besides, we have found no match at all between the budgetary strategy and the empirical data at all, with the exception of Portugal, which increased both revenues and expenditures as predicted.

¹⁷ The SGP has been revised exactly because of that reason. The countries in the eurozone must enhance budgetary discipline now in good times to create a buffer for bad times.

A number of explanations come to mind for the lack of support for Wildavsky's cultural theory of budgeting. First, the main hypothesis of Wildavsky's cultural theory is that the budgetary strategy is directed by the political culture may, of course, be wrong. Indeed, that may be possible, but it is still too early to draw that conclusion. On the positive side, the hypothesis served as a heuristic device, revealing that a decrease of revenues and expenditures dominates in a period of budgetary convergence and a decrease of revenues and an increase of expenditures prevail in times of fiscal consolidation.

In addition, the hypothesis may be blurred by, for instance, interfering variables. The first thing that comes to mind is a change in the political ideology of the political party in office, as left-wing governments are supposed to have a preference for spending (De Haan and Sturm 1994: 168), but Hahm et al. did not find much support for that hypothesis (Hahm, Kamlet and Mowery 1996: 68).¹⁸ The budgetary strategy may have suffered from elections as is illustrated by the French case. The former government had issued a package of measures leading to tax relief, whereas a tax increase would have been appropriate to reduce the deficit that hit the ceiling of the reference value for the third time in a row.

Besides, the economic situation may have forced the government in office to pursue another budgetary strategy than predicted by Wildavsky's cultural theory of budgeting. We have to take into account that European members states were not on equal footing at the time they agreed on the criteria for the participation in EMU (i.e. at the Maastricht Summit in December 1991). Countries, like Ireland, Luxembourg and the Netherlands were already in a good shape regarding their budgetary deficits (in terms of their performance relative to the reference value), but other countries like Greece, Italy and Sweden had to reduce considerably as they were running large budgetary deficits of more than 10 per cent of GDP. In a relatively short period they reversed the trend. Only two had difficulties: Greece overshot the reference value, whereas Portugal hit the ceiling. However, they had to pay a price in the form of a rising debt and, therefore, higher interest payments.

A second explanation for the mismatch between the political culture and the budgetary strategy may have to do with the indicators used for the independent and dependent variables. To start with the independent variable, one may argue that to characterization of political culture is too simple. In the theory it is characterized by only two variables - the number of prescriptions and the degree of individualism vs. collectivism – even though that worked in anthropology for

¹⁸. The same is true for Roubini and Sachs hypothesis about the relationship between the strength of the political party in office and (the size of) the budget deficit (Hahm et al. 1996: 68; De Haan and Sturm 1997: 749).

small groups. However, the outcome of the clustering is in line with other classifications that use more than two variables to measure political culture.

A similar argument can be made regarding the dependent variable: it is perhaps too simple to argue that the budgetary strategy is shaped only by changes in revenues and expenditures. A closer look at the spending side, notably the change in expenditures for investments and employment, is needed to find out if governments focus on the denominator rather than the numerator of the deficit/GDP ratio. After all, the deficit should disappear when the economy recovers. In addition, public debt and interest payments could be reduced as European member states with a high debt/GDP-ratio give priority to a reducing their debt.

Third, the empirical data may prove to be wrong. After all, the statistical data regarding the independent variable were collected for another purpose, i.e. to show international differences in work-related values, notably in the private sector (Hofstede 1984). One may argue that Wildavsky's cultural theory does not account for the dynamics of political regimes¹⁹ and, therefore, does not reflect the current state of affairs in European member states. Since, most European member states have gone through a process of deregulation and privatization both affecting Hofstede's indicator. However, he claims that 'culture' is stable over decades²⁰. Unfortunately, the empirical data needed to test Wildavsky's cultural theory of budgeting in a more dynamic way are not available.

The data regarding the dependent variable is collected and provided by individual European member states and may be biased and subject to interpretation as is shown by the Greek case. In addition, the statistical data not only reflect the budgetary strategy, but also the impact of other variables as an unpredicted growth in the demand for entitlement. A more refined analysis of the expenditures, that analyzes benefits and transfers (Alesina and Perotti 1995b), may provide better insight. However, the figures are checked and verified by Eurostat and then combined into a single format and can, as such, be considered as authoritative, reliable and valid.²¹

Last but not least, a more sophisticated method of inquiry may produce better results, though the degrees of freedom constitute a problem (Alesina and Perotti

¹⁹ A change of culture (macrochange) should be understood as the aggregation of changes of individual attitudes and behavior (microchange) (Thompson, Ellis and Wildavsky 1990: 77). A dynamic version of the cultural theory is provided by Gunnar Grenstad in his map of political cultures in Europe (Grenstad 1999)

²⁰ A culture is, as such, even harder to change than an institution (see Von Hagen 1992: 2; Alesina and Perotti 1995a: 23; Alesina and Perotti 1999: 15).

²¹ In addition, the data are adjusted for the cycle by DG ECFIN in charge of the monitoring of budgetary position of European member states.

1999: 31). Expanding the time horizon may add to the test of Wildavsky's cultural theory of budgeting. Additionally, the enlargement of the European Union to Central and Eastern Europe is promising as the number of test cases currently is too small for a more sophisticated method of inquiry. A first group of new European member states has applied for participation in EMU, but it will take years before that data may be included in the analysis of the 'policy mix' that European member states have put together to reduce their budget deficits below the reference value and then to consolidate their budgetary position.

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- Hofstede: <http://www.geert-hofstede.com>

ANNEX I: GEERT HOFSTEDE'S DATASET

Country	PDI	IDV	MAS	UAI	LTO
Austria	11	55	79	70	
Belgium	65	75	54	94	
Denmark	18	74	16	23	
Finland	33	63	26	59	
France	68	71	43	86	
Germany	35	67	66	65	31
Greece	60	35	57	112	
Ireland	28	70	68	35	
Italy	50	76	70	75	
Luxembourg*	40	60	50	70	
The Netherlands	38	80	14	53	44
Portugal	63	27	31	104	
Spain	57	51	42	86	
Sweden	31	71	5	29	33
United Kingdom	35	89	66	35	25

* Proxy on the basis of a cross-national comparison.

EXPLANATION

PDI: Power Distance Index
 IDV: Individualism
 MAS: Masculinity
 UAI: Uncertainty Avoidance Index
 LTO: Long Term Orientation

ANNEX II: GEERT HOFSTEDE'S INDICATORS

1. Power Distance Index (PDI) focuses on the degree of equality, or inequality, between people in the country's society. A High Power Distance ranking indicates that inequalities of power and wealth have been allowed to grow within the society. These societies are more likely to follow a caste system that does not allow significant upward mobility of its citizens. A Low Power

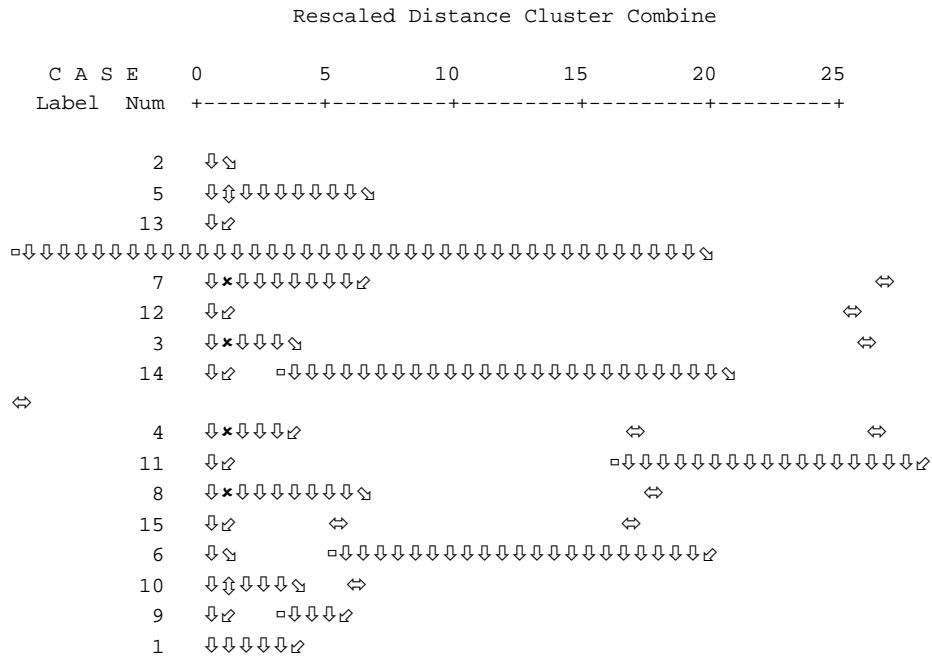
Distance ranking indicates the society de-emphasizes the differences between citizen's power and wealth. In these societies equality and opportunity for everyone is stressed.

2. Individualism (IDV) focuses on the degree the society reinforces individual or collective achievement and interpersonal relationships. A High Individualism ranking indicates that individuality and individual rights are paramount within the society. Individuals in these societies may tend to form a larger number of looser relationships. A Low Individualism ranking typifies societies of a more collectivist nature with close ties between individuals. These cultures reinforce extended families and collectives where everyone takes responsibility for fellow members of their group.
3. Masculinity (MAS) focuses on the degree the society reinforces, or does not reinforce, the traditional masculine work role model of male achievement, control, and power. A High Masculinity ranking indicates the country experiences a high degree of gender differentiation. In these cultures, males dominate a significant portion of the society and power structure, with females being controlled by male domination. A Low Masculinity ranking indicates the country has a low level of differentiation and discrimination between genders. In these cultures, females are treated equally to males in all aspects of the society.
4. Uncertainty Avoidance Index (UAI) focuses on the level of tolerance for uncertainty and ambiguity within the society - i.e. unstructured situations. A High Uncertainty Avoidance ranking indicates the country has a low tolerance for uncertainty and ambiguity. This creates a rule-oriented society that institutes laws, rules, regulations, and controls in order to reduce the amount of uncertainty. A Low Uncertainty Avoidance ranking indicates the country has less concern about ambiguity and uncertainty and has more tolerance for a variety of opinions. This is reflected in a society that is less rule-oriented, more readily accepts change, and takes more and greater risks.
5. Long-Term Orientation (LTO) focuses on the degree the society embraces, or does not embrace, long-term devotion to traditional, forward thinking values. High Long-Term Orientation ranking indicates the country prescribes to the values of long-term commitments and respect for tradition. This is thought to support a strong work ethic where long-term rewards are expected as a result of today's hard work. However, business may take longer to develop in this society, particularly for an "outsider". A Low Long-Term Orientation ranking indicates the country does not reinforce the concept of long-term, traditional orientation. In this culture, change can

occur more rapidly as long-term traditions and commitments do not become impediments to change.

ANNEX III: DENDROGRAM USING WARD METHOD

* * * H I E R A R C H I C A L C L U S T E R A N A L Y S I S * * *



EXPLANATION

- | | |
|------------|---------------------|
| 1. Austria | 9. Italy |
| 2. Belgium | 10. Luxembourg |
| 3. Denmark | 11. The Netherlands |
| 4. Finland | 12. Portugal |
| 5. France | 13. Spain |
| 6. Germany | 14. Sweden |
| 7. Greece | 15. United Kingdom |
| 8. Ireland | |

**ANNEX IV: BREAK-DOWN OF THE BUDGET DEFICIT
(NET BORROWING/NET LENDING)**

Deficit/ Surplus	1993	1994	1995	1996	1997	1998	1999	2000	2001	2002	2003	2004	2005	2006	2007
Actual Balance	NA	NA	-5,1	-4,2	-2,5	-1,7	-0,7	1	-1,2	-2,2	-2,9	-2,6	-2,7	-2,7	-2,6
Cycle	NA	NA	-0,3	-0,7	-0,5	-0,1	0,3	2,2	0,8	0,4	-0,2	0	-0,3	-0,3	-0,1
Adjusted Balance	NA	NA	-4,8	-3,5	-2	-1,6	-1	-1,2	-2	-2,6	-2,7	-2,6	-2,4	-2,4	-2,5
Interest	NA	NA	-5,3	-5,3	-4,8	-4,4	-3,9	-3,6	-3,5	-3,2	-3	-2,9	-2,9	-2,8	-2,9
Structura l Balance	NA	NA	0,5	1,8	2,8	2,8	2,9	2,4	1,5	0,6	0,3	0,3	0,5	0,4	0,4

ANNEX V: STRUCTURAL BALANCE, FY 1993-2007

Country	1993	1994	1995	1996	1997	1998	1999	2000	2001	2002	2003	2004	2005	2006	2007
Austria	0,2	-0,8	-1,5	0,2	2,4	1,3	0,8	0,7	3,2	2,8	2,1	2	1,2	1,2	1,4
Belgium	4,5	4,7	4,9	5,5	5,9	7	6,2	5,7	6,5	5,6	5,8	4,8	4,7	4,1	3,6
Denmark	6,3	4,1	3,9	4,3	4,6	4,9	5,5	5,2	4,8	4,5	4,8	6,1	6,2	5	4,4
Finland	1,8	1,9	2,7	3,2	3,1	4,3	4,2	8	7,1	6,1	4,3	3,5	4	3,7	3,5
France	-1,7	-1,3	-1,2	0,8	1,5	1,1	1,3	0,6	0,5	-0,8	-1,1	-0,9	-0,3	-0,4	-0,7
Germany	0,1	0,6	0,1	0,5	1,1	1,4	1,7	1,1	-0,6	-1	-0,5	-0,5	-0,4	-0,3	0
Greece	-0,1	5,3	3,3	5,4	5,6	5,8	5,6	4,2	0,5	1,2	-0,4	-1,7	1,1	0,8	0,6
Ireland	6,6	7,3	5	5,9	5,1	5,3	3,3	4,3	0,5	-0,7	0,6	2,3	0,8	1	1,1
Italy	3,9	3	4,1	4,8	6,9	5,3	5,1	3,8	2,4	2,6	2,1	1,8	1,1	0,8	0,4
Luxembourg	1,3	3,2	4,8	5,3	4,6	4,1	3,1	4,1	5,8	2,3	1	-0,6	-1,8	-1,6	-2
Netherlands	4,3	3,3	2,5	4,4	4,1	3,2	3,5	3,1	1,3	0,2	0	1	1,9	1,9	2
Portugal	0,5	0,6	1,9	1,6	1,1	0	-0,4	-1,6	-2,6	-0,9	0	-0,3	-2,9	-1,8	-1,7
Spain	NA	NA	-0,5	1,5	2,5	1,6	2,2	1,5	1,7	2	2,1	1,8	2,1	2	1,7
Sweden	-2,5	-1,2	0,2	4,8	6,3	7,8	6,4	7,5	5	2,5	2,7	3,3	3,2	2,4	2,6
United Kingdom	-4,4	-3,8	-2,6	-0,9	1	3	3,3	3,1	2,2	-0,2	-1,8	-1,9	-1,3	-1,1	-1
EU-12	NA	NA	0,9	2	2,9	2,5	2,6	2	1,1	0,6	0,6	0,6	0,7	0,6	0,5
EU-15	NA	NA	0,5	1,8	2,8	2,8	2,9	2,4	1,5	0,6	0,3	0,3	0,5	0,4	0,4
EU-25	NA	NA	NA	NA	NA	NA	NA	2,3	1,4	0,5	0,2	0,3	0,4	0,3	0,3

ANNEX VII: BUDGETARY STRATEGY PER CLUSTER

	FY 1993-1998			FY 1998-2003		
	ΔR	ΔE	ΔSB	ΔR	ΔE	ΔSB
Cluster I						
Greece	I	I	D	D	I	I
Portugal	I	I	I	I	I	B
Cluster IIA						
	ΔR	ΔE	ΔSB	ΔR	ΔE	ΔSB
Belgium	I	D	D	I	I	I
France	I	D	D	D	I	I
Italy	D	D	D	D	I	I
Spain	D	D	D	B	D	D
Cluster IIB						
	ΔR	ΔE	ΔSB	ΔR	ΔE	ΔSB
Austria	D	D	D	D	I	D
Finland	D	D	D	D	B	I
Germany	I	D	D	D	I	I
Luxembourg	D	D	D	D	I	I

Annex VII. (Continued)

	FY 1993-1998			FY 1998-2003		
	ΔR	ΔE	ΔSB	ΔR	ΔE	ΔSB
Cluster III	ΔR	ΔE	ΔSB	ΔR	ΔE	ΔSB
Denmark	D	D	I	D	B	I
Ireland	D	D	I	D	I	I
Netherlands	D	D	I	I	I	I
Sweden	D	D	D	D	I	I
United Kingdom	I	D	D	I	I	I

Explanation: ΔR = Change Revenues, ΔE = Change Expenditures; ΔSB = Change Structural Balance; B = Balance, D = Decrease, I = Increase

	Indicates match
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DIRECT TAXATION, THE ECJ AND IMPLICATIONS FOR MEMBER STATE BUDGETS

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ABSTRACT

This paper examines the potential impact of the direct taxation jurisprudence of the Court of Justice of the European Communities (ECJ) and, to a lesser extent, the Community restrictions on fiscal state aid, on member state budgetary discipline. Despite the theoretical retention by the member states of almost complete sovereignty in direct taxation, member states are increasingly finding their policy options for raising new tax revenue, preventing the erosion of their existing tax revenues and bases, and creating tax incentives to stimulate their economies limited by ECJ rulings. Recent and anticipated cases may have serious budgetary impacts for a number of member states, putting pressure on them to make changes to their tax systems. At the same time, the last year has brought a noticeable shift in perspective and emphasis in the decisions of the ECJ, which may be seen as a relaxation of its previous approach. The development of legal principles for limiting the pecuniary impact of ECJ rulings is now also the subject of intense consideration before the Court.

¹ An earlier version of this paper was presented at an international interdisciplinary conference on the 'Political and Economic Consequences of EMU' held 18-19 August 2005 at the University of Victoria. This is a revised and updated version to 10 September 2006.

1. INTRODUCTION

A member state of the eurozone loses many of the policy options for responding to changing global and domestic economic conditions simply by adopting the common currency. National interest and exchange rate policies are the two most obvious policy levers of which a country loses control when it joins a currency union such as the euro. The Stability and Growth Pact (SGP)² limits another option for policy makers, of running budget deficits (in excess of 3 per cent of Gross Domestic Product (GDP)) in years where tax revenues are insufficient to meet government expenditures. To a larger extent than finance ministries of countries outside the eurozone, those that have adopted the euro are left with the choice of raising taxes or creating new ones to increase revenue, or stimulating the economy through tax incentives, usually in specific sectors which are perceived as having potential to increase employment or trade, or attract investment (such as manufacturing or financial services). Both of these options are now being constrained by European Community (EC) law (Graetz and Warren 2006).

The last several years, corresponding with the third stage of Economic and Monetary Union (EMU), have seen the maturation of the jurisprudence of the Court of Justice of the European Communities (ECJ) with respect to the application of the free movement provisions of the Treaty establishing the European Community (TEC) to direct taxation measures. At the same time, the law of state liability and remedial and procedural compensation for breach of EC law has solidified. The relatively sudden and unforeseen effect of some of the rulings on the validity of national direct tax laws, and specifically corporation tax laws, may force some member states to fundamentally change their tax systems. In some cases, it is not possible to protect the treasury from the impact of the ECJ rulings, putting national budgetary equilibrium at risk.

On the other side of the budget balance sheet, member states who have relied on targeted tax incentives in the past to stimulate domestic economic growth or employment will be affected by the stricter enforcement of prohibitions on the provision of state aid. Although these member states will expend less on fiscal

² The Stability and Growth Pact is contained in two Council Regulations: 1466/97 [1997] O.J. L 209/1, 1467/97 [1997] O.J. L 209/6 and the Resolution of the European Council of 17 June 1997 [1997] O.J. C 236/1. Regulations 1466/97 and 1467/97 have been amended by Council Regulations 1055/2005 [2005] O.J. L 174/1 and 1056/2005 [2005] O.J. L 174/5, which significantly relax the strictness of the Pact, but retain the goal of a maximum deficit of 3 per cent of GDP. Member states which have not adopted the euro are required to observe the 3 per cent deficit rule.

incentives, to the extent tax incentives achieve the desired goals, usually to stimulate enterprise or investment, attract head offices, or promote employment and therefore the collection of social security charges, the overall budget balance could be adversely affected by the prohibition of state aid in the TEC.

One of the more disruptive effects of the recent legal developments in both direct taxation and state aid in the ECJ judgments is to make it more difficult for finance ministries to predict revenues and expenditures accurately. Not only is the outcome of a particular case sometimes unanticipated, but its application to past tax years may multiply its budgetary impact by many times. A ruling of the ECJ with respect to one member state's tax law may lead to uncertainty in other member states with similar tax measures until further litigation resolves the issue. A member state may enact measures in response to an ECJ ruling (or in anticipation of the ruling, in response to the opinion of the Advocate General) which, while intended to make the tax system compliant with EC law, makes it more complex, and less transparent and competitive globally. The new measures may themselves later turn out to be incompatible with EC law, as it is developing very rapidly. Responding to litigation before the ECJ is not a predictable and stable method for a national finance ministry to define the domestic limits of acceptable taxation and tax incentives.

It will be evident from the discussion below that the UK is the member state most vulnerable to recent and anticipated ECJ rulings on direct taxes. However, no member state is immune, as the ECJ rulings strike at assumptions and principles of domestic and international tax law on which European Union (EU) member states constructed their direct tax systems.

2. DIRECT TAXATION AND FUNDAMENTAL FREEDOMS

The process of elimination of direct tax obstacles to an integrated single market has been difficult and uneven, and is far from complete. Although it was early recognized³ that direct taxation laws of the member states could significantly inhibit free movement of services, persons, capital and most significantly, the right of establishment, positive harmonization has been impeded by the

³ For a detailed history of the various policies, studies and proposals from 1960 to 1992, see Easson (1992). See also the Opinion of Advocate General Maduro in Case C-446/03, *Marks & Spencer plc v. David Halsey*, at footnote 4 of the opinion, where the early proposal for a consolidated profit and loss regime is described.

requirement of unanimity in the Council.⁴ The reinvigorated push to achieve the single market by the end of 1992 resulted in two significant measures, the Parent-Subsidiary Directive⁵ and the Merger Directive.⁶ From 1990 until 2003, however, no further substantive direct taxation measures were adopted by the Council.⁷ In the absence of a programme of positive integration measures, taxpayers, both companies and individuals, began a campaign of challenges to national tax laws based on EU free movement guarantees.

The most important direct taxation⁸ effects for member state budgets result from the rulings on various national corporate taxation measures and their compatibility with the TEC guarantees of free movement of services and capital and the right of establishment.⁹ As the ECJ states as a matter of principle in each new ruling it delivers, 'although direct taxation falls within their competence, the Member States must none the less exercise that competence consistently with Community law'.¹⁰ In the last decade, the Court's jurisprudence in this area can be seen as imposing negative harmonization on the member states where the requirement of unanimity in the Council has prevented positive harmonization through directives.

The Commission took the early initiative in seeking to apply TEC free movement guarantees, with a direct action for failure to fulfil Treaty obligations

⁴ While TEC Article 95(1) generally allows for qualified majority voting in the Council on measures for the establishing and functioning of the internal market, Article 95(2) excepts fiscal measures, with the result that the unanimity required by Article 94 applies to direct taxation.

⁵ Council Directive 90/435/EEC OJ 1990 L 225/6. This directive required member states to eliminate tax on dividends paid by a subsidiary in one member state to a parent company in another member state by 31 December 1991. It was amended to expand its application by Council Directive 2003/123/EC of 22 December 2003.

⁶ Council Directive 90/434/EEC OJ 1990 L 225 p. 1. This complex measure was designed to allow deferral of taxation on the cross-border reorganization of corporate groups after 31 December 1991. It also has been amended recently by Council Directive 2005/19/EC, 17 February 2005.

⁷ The Interest and Royalties Directive, Council Directive 2003/49/EC of 3 June 2003, O.J. 2003, L 157/49 and the Savings Directive, Council Directive 2003/48/EC of 3 June 2003, O.J. 2003, L 157/38 were finally adopted in 2003, despite having been proposed more than a decade previously.

⁸ A ruling that an indirect tax measure is incompatible with Community law may of course have extreme consequences for a member state's budget. In pending Case C-475/03 *Banca Popolare di Cremona* the amount of tax in issue is estimated at €120 billion. The implications of indirect tax cases for member states' budgets is beyond the scope of this paper.

⁹ There have also been numerous cases on direct taxation and the free movement rights of workers. While not to be ignored, these tend to affect tax collections much less seriously. This is partly because the amounts in issue are quite small, and the tendency for other individuals to bring new actions based on an ECJ ruling is constrained by cost. In addition, the personal tax systems and tax treaty provisions governing employees vary widely, so that a ruling in one case may not apply in other member states or to individuals in different family and employment circumstances.

¹⁰ See Case C-319/04 *Manninen* [2004] ECR I-7477 at [19].

against France commenced in the early 1980s.¹¹ The ECJ held that the right of establishment required France to extend the same tax credit to French branches of companies resident in other EU member states in respect of dividends received on shares that French resident companies enjoyed.

Immediately, subsequent cases were less successful. In two related rulings released together in 1992,¹² the ECJ upheld the ‘cohesion of the national tax system’ as justifying an infringement of a fundamental freedom. It held that a member state could deny a deduction for pension contributions paid by a resident individual to a pension provider established in another member state, while allowing the deduction for contributions to a pension provider established within its borders. The ECJ considered that there was no less restrictive method of ensuring that, where the member state of residence had allowed the contributor a tax deduction at the time of making the contributions, the pension benefits which would later be subject to tax in that member state. Accordingly, the preservation of the cohesion of the national system required that the deduction be denied. The cohesion argument is almost always put forward by member states in defence of their national tax measures, but has not been successful in any subsequent cases.

After this uncertain beginning,¹³ the challenges launched by taxpayers in their national courts against national tax laws and referred to the ECJ for preliminary rulings¹⁴ became more frequent, and almost always successful. By the mid-1990s, the general EC law regarding non-discrimination on the basis of nationality and the prohibition of restrictions on free movement of services and the right of establishment had evolved to support a wide range of challenges to direct tax measures.¹⁵ Beginning in the late 1990s, direct tax rules that discouraged EC based service providers from competing in a particular EC domestic market, or which inhibited purchasers of services from seeking services outside their member state of residence were regularly held to be contrary to TEC Art. 49 and thus

¹¹ Case 270/83 *Commission v. France* (*‘Avoir Fiscal’*) [1986] ECR 273.

¹² Case C-204/90 *Bachmann v. Belgian State* [1992] ECR I-249; Case C-300/90 *Commission v. Belgium* [1992] ECR I-305.

¹³ In the same period, the ECJ ruled in favour of a taxpayer on an issue which was largely to do with an administrative presumption which discriminated against former residents (Case 175/88 *Biehl* [1990] ECR I-1779) and against two other taxpayers in cases relying on the right of establishment: Case 81/87 *Daily Mail* [1988] ECR 5483 and Case C-112/91 *Werner* [1993] ECR I-429. It was thus not immediately clear that the ruling in *Avoir Fiscal* had begun a new line of jurisprudence until later cases began to overwhelmingly favour the taxpayer.

¹⁴ Pursuant to the procedure provided in TEC Article 234.

¹⁵ In decisions such as Case C-415/93 *Bosman* [1995] ECR I-4921 and Case C-55/94 *Gebhard* [1995] ECR I-4615 the Court has laid down broad principles regarding restrictions on free movement of services and the right of establishment analogous to the famous *Cassis de Dijon* ruling in the area of restrictions on free movement of goods.

'inapplicable'.¹⁶ Tax measures which favoured resident over non-resident corporations, or discouraged resident corporations from establishing branches or subsidiaries in other member states similarly fell to taxpayer challenges based on the right of establishment in TEC Arts. 43-48.¹⁷ As the free movement of capital provisions of the TEC were given substance by Council directives, taxpayer challenges to laws that favoured domestic investment or investors over capital flows to or from other member states proliferated.¹⁸

In the last few years, the Commission has become much more active in bringing infringement actions, pursuant to TEC Art. 226-228, against member states' direct tax measures. Between the *Avoir Fiscal* case commenced in 1983, and 1998, it initiated only two actions challenging member states' direct tax laws, and both of these followed initial action by the affected taxpayer. The Commission did present observations, usually supporting the taxpayer, in most of the cases which came before the ECJ in the interim, so it must be acknowledged that it has played an important role in the development of the case law. The Commission is now systematically taking action against member states in the sphere of pensions taxation and other areas,¹⁹ and is even using 'soft law' methods to encourage reform of national tax systems.²⁰

¹⁶ Case C-294/97 *Eurowings* [1999] ECR I-7447 (aircraft leasing); Case C-118/96 *Safir* [1998] ECR I-1897 (pensions); Case C-136/00 *Danner* [2002] ECR I-8147 (pensions); Case C-42/02 *Lindman* [2003] ECR I-13519 (lotteries); Case C-422/01 *Skandia and Ramstedt* [2003] ECR I-6817 (pensions); Case C-234/01 *Gerritse* [2003] ECR I-5933 (services of a self-employed musician).

¹⁷ Among others, Case C-264/96 *ICI*, [1998] ECR I-4695; Case 307/97 *St. Gobain, ZN* [1999] ECR I-6161; Case C-200/98 *X AB and Y AB v. Riksskatteverket* [1999] ECR I-8261; Case C-251/98 *Baars* [2000] ECR I-2787; Joined cases C-397/98 and C-410/98 *Metallgesellschaft and others* [2001] ECR I-1727; Case C-141/99 *AMID* [2000] ECR I-11619; Case C-324/00 *Lankhorst-Hohorst* [2002] ECR I-11779; Case C-168/01 *Bosal Holding BV v. Staatssecretaris van Financiën*, [2003] ECR I-9409; Case C-9/02 *De Lasteyrie du Saillant* [2004] ECR I-2409.

¹⁸ Case C-35/98 *Verkooijen* [2000] I-4073; C-478/98 *Commission v. Belgium* [2000] ECR I-7587 ('*Eurobonds*'); Case C-315/02 *Lenz* [2004] ECR I-7063; *Manninen*, cited above, note 5; and see Leo Flynn, 'Coming of Age: The Free Movement of Capital Case Law 1993-2002', *CML Rev* (2002), 773-805.

¹⁹ For example, the Commission has recently taken coordinated action against several member states' taxation laws which discriminate against foreign pension funds: Commission Press Release IP/03/179 'Pension taxation: Commission tackles discrimination against foreign pension funds in six Member States', 5 February 2003. Three cases are currently pending before the ECJ in this area: Case C-522/04 *Commission v. Belgium*, Case C-150/04 *Commission v. Denmark*, and Case C-47/05 *Commission v. Spain*. The perception of increased activity by the Commission may in part be due to easier access to information, but also reflects an express policy of the Commission announced in 2001 in Communication from the Commission, 'Tax policy in the European Union – Priorities for the years ahead', COM(2001) 260 final, at p. 23.

²⁰ See for example the Communication from the Commission to the Council, the European Parliament and the European Economic and Social Committee, 'Dividend taxation of individuals in the Internal Market' COM(2003) 810 final. In this Communication the

Member states have vigorously defended their tax laws, but the great majority of ECJ rulings have favoured the taxpayer. Most significantly in the context of the impact on member state budgets, the ECJ has clearly rejected attempts by member states to justify their tax laws which restrict free movement on the basis of protection of government revenues or of the tax base from erosion.²¹ Further, high tax jurisdictions may not justify a tax measure on the basis that it equalizes the tax burden on lower taxed income from sources in other EU member states with the tax burden on domestically sourced income by imposing differential internal tax measures.²² The ECJ can thus be seen as indirectly encouraging intra-EU tax competition and pursuing, step by step, the negative integration of direct taxation where positive harmonization has been politically impossible.

3. MEMBER STATE OBLIGATIONS TO PROVIDE COMPENSATION FOR BREACH OF EC LAW

3.1. Remedies

The right of a person to recover charges which a member state has levied contrary to EC law was first established in relation to free movement of goods and the Treaty prohibition on customs duties and discriminatory internal taxes.²³ When later cases began to find national direct taxation measures were contrary to EC law, the right of the taxpayer to recover improperly assessed corporate or income tax followed naturally, as these cases are generally in the form of appeals of assessments brought by taxpayers in national courts. Member state tax laws generally provide for refunds of tax collected under invalid assessments.

There is a considerable body of jurisprudence on remedies available to individual victims of infringement of EC legal obligations by member states. In the early cases, the ECJ accorded precedence to national legal systems to determine what remedy was available and the procedure for pursuing it.²⁴ In later decisions, the ECJ's concern has been to ensure that Community law is effective

Commission clearly calls on member states to amend their dividend taxation regimes that are incompatible with free movement of capital, and indicates its willingness to take infringement proceedings if necessary.

²¹ In *Manninen* at [49] and *Lankhorst-Hohorst* [36] (cited above, footnotes 11 and 18 respectively) the Court referred to this principle as 'settled law'.

²² *Eurowings* and *Safir*, cited above, footnote 16.

²³ See Case 199/82 *Amministrazione delle Finanze dello Stato v. San Giorgio* [1983] ECR 3595.

²⁴ An example is Case 6/60 *Humblet* [1960] ECR 559, in which the ECJ refused to strike down a tax assessment found to be in conflict with Community law.

in safeguarding the rights of citizens, including corporations, conferred by the Treaty.²⁵ The Court's case law now requires that national law provide a procedure and a remedy for infringement of EC law that is no less favourable than that available in analogous domestic actions, and which does not make it practically impossible or excessively difficult to exercise rights conferred by EC law.²⁶ These are the principles of equivalence and effectiveness, and the failure of a member state to ensure that its civil liability system reflects these principles is itself a failure to fulfil Treaty obligations.

The requirement that equivalent and effective remedies and procedures be available for breaches of EC law which result in unlawful collection of tax means that interest will usually be payable by the national treasury to the taxpayer in respect of the period the tax was retained. Even when the breach takes the form of a mere denial of a deferral of payment of tax, the member state must compensate the taxpayer for the loss of use of its funds during the period it ought to have been able to defer payment.²⁷

3.2. Procedural Considerations

A single taxpayer testing a minor provision of domestic tax law obviously does not present a threat to the nation's budgetary stability. However, it can trigger large numbers of tax appeals by other taxpayers relying on the same arguments if the first challenger is successful before the ECJ. In the realm of international corporate taxation, sophisticated multinational corporations respond rapidly to ECJ rulings which could allow them to recover back taxes by refile their tax returns from previous years or challenging assessments not only in the member state directly affected by a ruling, but in other member states in which they pay tax and whose legislation may be vulnerable to the same challenge.

A new phenomenon in the UK is the use of a form of class action to recover taxes paid under laws subsequently held to be incompatible with EC law. This grew out of the joined cases *Metallgesellschaft and Hoechst*,²⁸ in which the UK's imputation system for alleviating double taxation of corporate profits and the

²⁵ This may require a member state to pay damages or restitution to a person who has suffered loss due to the government's failure to fulfil its Treaty obligations: Joined Cases C-6 and 9/90 *Franco v. Italy* [1991] ECR I-5357 and the leading decision, Case C-46/93 *Brasserie du Pêcheur SA* [1996] ECR I-1029.

²⁶ See Case C-62/00 *Marks & Spencer* [2002] ECR I-6325, at [30]. This case is not to be confused with Case C-446/03, also called *Marks & Spencer*, discussed in detail below.

²⁷ *Metallgesellschaft*, cited above, footnote 17 at [84]-[86].

²⁸ *Ibid.*

dividends distributed from such profits came under attack. In 2001, the ECJ ruled that the failure of the UK corporation tax law to offer the same election to defer payment of a portion of their corporate tax liability to subsidiaries of parent companies resident in other member states that it offered to subsidiaries of British companies was contrary to the right of establishment. Even though there was no difference in the final amount of tax payable by the two groups, the lack of access to the deferral election caused the British subsidiaries of EC parent companies to suffer a cash flow disadvantage. The ECJ considered this to be indirect discrimination on the basis of nationality.

Claims by other multinational groups for compensation based on the *Metallgesellschaft* ruling multiplied. In 2001, the first ‘group litigation order’ in a tax case was made, and as many as 160 multinationals have joined the group. The group litigation order allows all similar claims to be consolidated and pursued by the group, with a few claimants’ cases being presented as test cases, which then determine the outcome for the whole group of litigants. Each individual claimant’s costs, and risk, of pursuing the action are greatly reduced. There are now at least six group litigation orders relating to corporation tax in the UK²⁹ and four test cases arising from these orders have been referred to the ECJ for preliminary rulings.

The issue of how many years back the taxpayer can claim a refund of tax is normally governed by national laws on limitation of actions. Provided an action based on EC law is treated as favourably as one based on domestic law, and the limitation period is not so short as to make recourse practically impossible, the national law will survive.³⁰ However, in the first *Marks and Spencer* case,³¹ the ECJ held that a retroactive UK law shortening the limitation period for claiming refunds of tax was prohibited by the principle of effectiveness. The UK advance corporation tax system which was challenged in *Metallgesellschaft* was abolished in 1999, but the claims for restitution or damages for breach of EC law are still ongoing, with claims as far back as the 1995 fiscal year having been held to be compensable.³²

²⁹ See Rae (2004).

³⁰ Case C-188/95 *Fantask* [1997] E.C.J. I-6841.

³¹ Cited above, note 26.

³² See *Inland Revenue v. Deutsche Morgan Grenfell* 2005 EWCA Civ. 78, decided 4 February 2005. An appeal to the House of Lords is pending. The High Court [2003] EWAC 1779 (Ch.) (18 July 2003) ruled that taxpayers could claim restitution of taxes paid back to 1973, the year the UK joined the EEC.

4. TYPES OF DIRECT TAX MEASURES WHICH CONFLICT WITH TEC FREEDOM OF MOVEMENT GUARANTEES

It is possible to identify several areas where the effects of recent or anticipated rulings by the ECJ are, or may be, serious enough to require fundamental change to a member state's tax system, or to have a significant impact on its budget balance, or both. The first two examples are of defensive measures which are used to protect a country's tax base from what may be considered undue erosion, and which are widely viewed as acceptable amongst member states and other industrialized countries. The third and fourth examples illustrate the conflict between the normal international territorial allocation of profits and losses between residence and source jurisdictions, and emerging principles of EC law which override the normal allocation within the EU.³³ The fifth example demonstrates how member states' systems of dividend taxation, many of which were recently reformed, have been found to be contrary to the provisions of the TEC guaranteeing free movement of capital.

The recent decision in Case C-446/03 *Marks and Spencer* and a number of pending cases have presented the ECJ with an opportunity to apply a more nuanced approach to the relationship between direct taxation and fundamental freedoms. Beginning in mid-2005³⁴ a greater willingness to take into account the principles of international tax law, the interests of the member states, and the limitations of EU competence in direct tax matters has become evident in a few decisions of the ECJ, and is even clearer in certain opinions of the Advocates General. At time of writing there is still considerable uncertainty as to whether these indications of a less rigid approach will be generally adopted and applied over the long term.

³³ For a full description of this phenomenon, see Wattel (2003).

³⁴ Case C-376/03, the *D* Case, 5 July 2005, not yet reported, may turn out to be, in retrospect, the case which signalled a slight shift in the ECJ's approach to direct taxation and fundamental freedoms. In it the Court recognizes the limits of EU competence in this subject area, and strongly affirms the member states' ability to treat residents of other member states differently, depending on their state of residence and the terms of a bilateral tax treaty between two member states.

4.1. Thin Capitalization Rules: *Lankhorst-Hohorst*

A common type of defensive measure used by some western industrialized countries to protect their domestic tax base from erosion³⁵ is known as ‘thin capitalization’ rules. These rules restrict the amount of interest that a subsidiary of a foreign corporation can deduct in computing its tax liability in the subsidiary’s host state based on the debt-equity ratio of the parent’s capital investment in the subsidiary. Some thin capitalization regimes treat the disallowed interest as a dividend. The idea is to ensure that the subsidiary is adequately capitalized with equity by its parent corporation, and not solely with debt owing to the parent. The subsidiary is then more likely to produce profits that will be taxable by the host state, which often has (in the absence of the thin capitalization rules) a higher effective corporate tax rate than the jurisdiction where the parent is taxable. This removes any incentive for the parent company to strip profits out of the subsidiary in the form of interest, and thus limits erosion of the tax base of the host country.

In *Lankhorst-Hohorst GmbH v. Finanzamt Steinfurt*,³⁶ the German thin capitalization rules were held to be contrary to the right of establishment, as they restricted the deduction by German subsidiaries of interest paid to non-German parent companies (in that case a Netherlands company), but not interest paid to a German parent company. The difference in treatment was considered to be an obstacle to the exercise of the right of establishment by companies from outside Germany, as the rules made it less attractive to create or acquire subsidiaries in Germany.³⁷

Nor could the German thin capitalization rules in that case be justified by either the objective of preventing reduction in tax revenue or tax evasion. As noted earlier, the ECJ stated that it is settled law that the reduction of tax revenue ‘cannot constitute an overriding reason in the public interest which may justify a measure which is in principle contrary to a fundamental freedom’.³⁸ And while the prevention of tax evasion is in principle a justification, the legislation applied generally to all situations where the lending parent company was non-resident, and so did not have the required specific purpose of preventing ‘wholly artificial

³⁵ Indeed, the Organisation for Economic Cooperation and Development (OECD) encourages its members to adopt thin capitalization rules as part of a coordinated defence against abuse by taxpayers of tax havens and other low tax jurisdictions. See OECD (2004a: 15).

³⁶ Cited above, footnote 17.

³⁷ France’s thin capitalization rules were held to be incompatible with the right of establishment by the Conseil d’État in a decision in late December 2003, Decision no. 249047, *SARL Coreal Gestion*.

³⁸ Manninen and Lankhorst-Hohorst, see footnote 21 above.

arrangements designed to circumvent the national tax laws'. Further, there was no abuse shown in the circumstances of the case.

In response to the judgment in *Lankhorst-Hohorst*, several EU member states, including the UK and Germany, amended their thin capitalization rules so that they applied equally to restrict deduction of interest by subsidiaries of domestic and foreign companies.³⁹ Although the issue of compatibility with EC law is eliminated, this constrains the financing options for groups which operate within a member state, as well as those that operate cross-border, and potentially makes the jurisdictions who have adopted these new rules less competitive compared to member states that do not have thin capitalization rules, or which only apply them where the lender is based in a tax haven.⁴⁰

Thin capitalization rules are again before the ECJ in Case C-524/04 *Test Claimants in the Thin Cap Group Litigation*. This time it is the UK rules that are challenged, and the case is proceeding under a group litigation order, with certain 'test cases' of the group referred to the ECJ for a preliminary ruling. Advocate General Geelhoed delivered his opinion on June 29, 2006. In the Advocate General's view, the UK rules can be justified by the need to prevent tax evasion as they incorporate the internationally accepted arm's length standard of reasonableness of the interest charges claimed as deductible and provide an exemption for transactions shown to have been carried out for genuine commercial reasons. On the condition that the UK tax authorities ensure that any interest treated as a dividend by the UK authorities receives corresponding treatment under the law of the parent company's member state, the rules are justified and proportionate.

If the Court adopts the Advocate General's recommendations, the UK will have revised its thin capitalization rules to apply to loans made to UK subsidiaries by both resident and non-resident parent companies in vain. While the Exchequer will be saved the expense of having to refund significant amounts of tax, the disruption and inefficiency of unnecessarily changing tax laws and then perhaps changing them back, has costs for both government and taxpayers as well.

³⁹ The UK's thin capitalization rules have been referred to the ECJ in a test case governed by a group litigation order. See pending case C-524/04, [2005] O.J. C 57/35.

⁴⁰ Spain amended its thin capitalization rules so that they do not apply where the parent is resident in Spain or another EU Member State, other than Cyprus and Malta, which Spain treats as tax havens. See Tax Analysts Worldwide Tax Daily, 27 December 2004, 2004 WTD 248-7.

4.2. CFC Provisions: Cadbury-Schweppes plc v. Commissioners of Inland Revenue

Another defensive measure used by most of the EU 15,⁴¹ as well as Canada, the United States and Japan to protect their tax bases are controlled foreign corporation,⁴² or 'CFC', rules. Such rules require a domestic corporation with a significant holding in a foreign subsidiary to pay tax on the foreign subsidiary's profits as they are earned in the foreign jurisdiction (and before they are distributed to shareholders), as if the profits belonged to the domestic corporation. This eliminates any deferral (or avoidance) of taxation of these profits which could be gained by using a subsidiary in a low tax jurisdiction to earn and retain the profits, rather than distributing them as dividends to the parent.

In the *Cadbury-Schweppes* case,⁴³ the UK's CFC rules are challenged as constituting restrictions on the free movement of services and capital and the right of establishment. The UK parent corporation utilized two Irish financing subsidiaries which benefited from the extremely favourable Irish tax rate of 10 per cent applied to companies established in the International Financial Services Centre in Dublin. The UK CFC rules require the profits of the Irish subsidiaries to be taxed in the hands of the UK parent in the year they are earned by the subsidiaries, because the subsidiaries' profits were subject to Irish tax at a rate which is less than three-fourths of the parent company's UK tax rate. This treatment effectively ignores the separate legal identity and foreign residence of the Irish subsidiaries.

In his opinion delivered on 2 May 2006, Advocate General Léger stated that the exercise of the freedom cannot give rise to a presumption of tax evasion or avoidance, nor can it be hindered by the claim that it has been exercised due to the low level of taxation in the host state. The Advocate General noted the existence of tax competition between member states, specifically with respect to very low rates applied in some member states, but says this is a political issue, not a legal one. Following the ECJ's ruling in Case C-446/03 *Marks and Spencer* (discussed below) the Advocate General ruled that freedom of establishment is not infringed by CFC legislation such as the UK's where the profits of the subsidiary in its state of residence are subject to a much lower level of taxation than in the parent

⁴¹ In the recent decision of the Special Commissioners in *Cadbury-Schweppes*, 2004 UK SPC00415 (6 June 2004) ten member states plus Norway were listed as having CFC legislation.

⁴² This type of provision is referred to by the acronym used in the United States, which in the 1960s was the first country to enact such legislation. As with thin capitalization rules, CFC provisions are recommended by the OECD as a legitimate means of combating tax base erosion through tax havens and other low tax jurisdictions. See footnote 34 above.

⁴³ Pending Case C-196/04.

company's state of residence, and that the legislation applies only to wholly artificial arrangements intended to circumvent national law. If an exemption is provided where it is proved that the subsidiary is genuinely established and carrying on an activity which is not devoid of economic purpose, then the rules are proportional. It was left for the national court to determine whether these conditions are in fact established.

At time of writing the ECJ has not ruled in this case so the test of validity of CFC rules is not yet clear. Further references to the ECJ concerning the validity of the UK's new CFC rules, amended as of 2001, are pending.⁴⁴ The Swedish CFC rules have been declared to be contrary to freedom of establishment by the Swedish tax authorities in an advance tax ruling on 4 April 2005.⁴⁵ Other member states have amended their CFC rules in advance of a ruling by the ECJ to ensure they comply with EU law.⁴⁶

What is very clear is that the cases on fundamental freedoms and direct taxation are multiplying in number, and a clarity and predictability of outcome have not been established in the existing jurisprudence. Again, if the Advocate General's opinion is followed by the ECJ, the treasury will be spared, at least in some CFC cases, but certainty in the law and in the budget planning of the member states will have yet to be achieved.

4.3. Limitation on Deduction of Charges Related to Foreign Subsidiaries: *Bosal Holding BV*

The Netherlands Law on Corporation Tax of 1969 did not allow the deduction by a Netherlands parent company of expenses, such as interest on funds borrowed to capitalize the subsidiary or costs of managing the subsidiary, unless the subsidiary directly or indirectly earned income taxable in the Netherlands. The theory was simple: if the profits of the foreign subsidiary are not subject to Netherlands taxation, then the expenses incurred by the parent company should not be deductible for purposes of computing the parent's Netherlands tax liability.

In the *Bosal Holding* case of 18 September 2003⁴⁷ the ECJ ruled that the denial of the deduction to the parent company was an obstacle to the creation of

⁴⁴ Pending Case C-203/05, *Vodafone 2*. See also pending Case C-201/05 – *Test Claimants in the CFC and Dividend Group*, one of the references in a case subject to a group litigation order.

⁴⁵ See Loyens & Loeff, EU Tax Alert No. 30, May 2005, available on line at www.loyensloeff.biz.

⁴⁶ See Tax Notes Int'l, 17 January 2005, 2005 WTD 13-4 in which the amendments to France's CFC rules, excluding their application where the foreign entity is resident in an EU member state, are described.

⁴⁷ Cited above, footnote 17.

subsidiaries which did not directly or indirectly generate taxable profits in the Netherlands. Such subsidiaries were far more likely to be established outside the Netherlands (as subsidiaries based in the Netherlands would normally have profits taxable in the Netherlands), so that the effect was to discriminate against parent companies with subsidiaries established outside the Netherlands. This could dissuade a parent company from carrying on activities in other member states through subsidiaries established there and accordingly violated TEC Art. 43. The ECJ dismissed the arguments of the Netherlands government, supported by the UK (and, unusually, the Commission), based on territoriality, cohesion of the Netherlands tax system, and prevention of erosion of the tax base going ‘beyond mere diminution of tax revenue’. In particular, the Court held that the argument that the disallowance of the deduction in these circumstances was necessary to maintain the cohesion of the Netherlands tax system was inapplicable. The denial of the deduction of expenses was in relation to a different legal entity (the parent company) than the balancing factor, the taxation of the profits the foreign subsidiary. There was thus no direct link between the deduction and inclusion in respect of the same taxpayer, which the court has repeatedly held to be necessary for the cohesion defence to succeed.⁴⁸

The Netherlands government responded immediately to the ruling in *Bosal*, submitting a proposal for amendment of the tax law to parliament in October 2003. Described as being intended to limit the ‘potentially disastrous budgetary consequences’⁴⁹ of the *Bosal* case, the amendments allowed the deduction of all costs of Dutch parent companies related to their holdings in subsidiaries, regardless of where the subsidiaries’ profits are subject to tax. It also introduced thin capitalization rules limiting interest deductibility on loans between related corporations whether the borrower is resident in the Netherlands or in another country. In early 2004 the Dutch government proposed a more comprehensive overhaul of the Netherlands’ corporate income tax system, to come into force in 2007, to make it compatible with EU law and make the Netherlands more competitive as an investment destination. This is a clear indication that the rulings of the ECJ are putting pressure on Dutch tax policy makers.

The *Bosal* ruling’s effects are not limited to the Netherlands, as many other member states had or have tax laws analogous to the Netherlands provision ruled incompatible with EC law in that case. Germany’s limitations on deductions by

⁴⁸ See, among many other cases, Case C-107/94 *Asscher* [1996] I-3089 at [58] and *Lenz*, footnote 18 at [36].

⁴⁹ Confédération Fiscale Européenne Opinion Statement on the decision of the European Court of Justice in *Bosal Holding BV v Staatssecretaris van Financiën*, C-168/01, available on line at: http://www.cfe-eutax.org/FRAMES_TOTAL/total_activities_events.html

German parent companies related to their foreign subsidiaries were recently held incompatible with freedom of establishment.⁵⁰

The options for member states whose tax laws resemble those ruled incompatible with EC law in *Bosal* include allowing a deduction of all charges relating to both domestic and foreign subsidiaries, which would have a significant impact on member states' budgets.⁵¹ Alternatively, the deduction could be eliminated for expenses related to domestic subsidiaries. This could cause multinational groups to seek more tax competitive base countries, outside the EU or in lower tax EU member states, which would also reduce tax revenue for the member state of origin.

4.4. Group Loss Relief: *Marks and Spencer*

*Marks and Spencer*⁵² was a closely watched and highly anticipated case by press, business and lawyers alike. It was a particularly threatening case for the UK Exchequer, and evidently for other member states' Treasuries as well, as seven member state governments submitted observations. The taxpayer claimed that the UK system of allowing the transfer and offsetting of losses of foreign branches but not losses of foreign subsidiaries against the parent company's profits infringes the freedom of establishment, which includes the freedom to choose the form of establishment (i.e. a branch or subsidiary). The taxpayer relied on *ICI v. HM Inspector of Taxes*,⁵³ a 1998 ECJ ruling that held that it was discriminatory to allow group loss relief only where the majority of the parent or holding company's subsidiaries were resident in the UK, and of course, on *Bosal Holding*.

The Court held that the denial of group loss relief where the subsidiary which sustained the losses was not resident in the UK was a restriction on the exercise of freedom of establishment, as the relief was available if the subsidiary was a UK resident. However, in considering whether the restriction was justified, the ECJ expressly recognized the validity of the international tax principle of territoriality, and that it formed part of EC law. It reiterated its position that reduction in tax revenue cannot constitute a justification for a measure which contravenes a fundamental freedom, but held that the consequences of extending the group loss

⁵⁰ Case C-471/04 *Keller Holding GmbH*, February 23, 2006, not yet reported. It must also be noted that *Bosal* has been criticized in the academic literature, and Advocate General Geelhoed recently expressed the opinion that it was wrongly decided in Case C-374/04 *Test Claimants in Class IV of the ACT Group Litigation*, delivered the same day as the ECJ's ruling in *Keller*.

⁵¹ See CFE Opinion Statement, cited above footnote 49.

⁵² Case C-446/03, December 13, 2005 not yet reported.

⁵³ Cited above, footnote 17.

relief rules unconditionally to non-resident subsidiaries had to be taken into account.

The ECJ accepted the three bases of justification put forward by the UK government. The first might be viewed as cohesion in a new international guise: “preservation of the balanced allocation of power to impose taxes between Member States”.⁵⁴ Companies should not be able to choose to have their losses taken into account in either their member state of establishment or another member state, as this would shift tax base between member states. The risk that losses could be used twice in two member states was also a justification for rules denying cross border loss relief, as was the risk that corporate groups could shift losses to high tax jurisdictions to unduly maximize their advantageous use. The UK rules were in principle justified as pursuing legitimate objectives compatible with the Treaty and suited to attaining such objectives.

However, on the question of proportionality, the ECJ held that the UK rules went beyond what was necessary to attain their objectives. A rule which made group loss relief conditional on the UK parent demonstrating that the foreign subsidiary had no possibility of taking the losses into account in its member state of residence, or which required a UK parent company to include in its own taxable profits the profits of its foreign subsidiaries to the extent that the latter’s foreign losses had been utilized by the parent company, would have met the test of proportionality.

It was left for the national court to determine whether in each case the foreign subsidiary had no possibility of deducting the losses in its State of residence. On 10 April 2006 the High Court of Justice ruled that Marks and Spencer could not claim relief for the losses of its French subsidiary, and referred the issue of the losses of the German and Belgian subsidiaries back to the Special Commissioners (Tait 2006).

This is the first decided case in which an EU member state government has successfully put forward the risk of tax avoidance as a justification, and, as mentioned earlier, it may be seen as a broader application of this justification by the ECJ.⁵⁵ The practical outcome of *Marks and Spencer* for the UK and other member state governments is not clear, given the conditionality of the decision, but the loss to the UK Treasury has been estimated at over a billion euros (EU business 2005). The issue that arose in *Marks and Spencer* is also being pursued in other cases subject to a group litigation order, and at least 59 companies have

⁵⁴ See the Opinion of Advocate General Geelhoed in Case C-524/04 *Test Claimants in the Thin Cap Group Litigation*, June 29, 2006 at [88].

⁵⁵ See the Opinion of Advocate General Léger in Case C-196/04, 29 May 2006 at [93].

joined the group. Only a few EU member states' tax systems⁵⁶ will comply with EC law if the ECJ finds the UK rules are incompatible. A challenge to Finnish group loss relief rules is pending before the ECJ,⁵⁷ and a Swedish court has already held that country's equivalent regime to infringe the right of establishment.⁵⁸ Some EU member states have already taken steps to bring their tax systems within the anticipated ruling of the ECJ, which would represent a fundamental change to prevailing norms of international tax law.

4.5. Taxation of Dividends from Domestic vs. Foreign Companies

A series of cases since 2000 have demonstrated that member states' tax laws restrict free movement of capital in various ways by favouring investment by individuals in shares of resident companies. In *Verkooijen*⁵⁹, the ECJ ruled that a Netherlands tax exemption of up to 2000 NLG from tax on dividends received from companies established in the Netherlands (but not on dividends from companies resident in other member states) discriminated against investors in companies in other member states and thus infringed the TEC provisions on free movement of capital.

This has resulted in other challenges to member states' taxation of dividends received by individuals. In *Lenz v. Finanzlandesdirektion für Tirol*,⁶⁰ the former Austrian dividend imputation system was held to be contrary to EC law. Under the Austrian tax system, companies established in Austria were taxed on their profits, and individual shareholders were taxed on dividends received from both Austrian and foreign companies. However, where the dividends came from Austrian companies, 25 per cent of the dividend was withheld at source, and the shareholder was entitled to exclude the dividend in computing income for tax purposes. The shareholder could also elect to be taxed on the dividend at 12.5 per cent, if that was more advantageous. If the dividend came from a non-Austrian company, the shareholder had to include it in computing income subject to Austrian tax, with the result that it was fully taxed at the taxpayer's marginal rate. This method of taxing Austrian shareholders was a means of eliminating economic double taxation within Austria which would result from taxing both the

⁵⁶ Loyens and Loeff *EU Tax Alert No. 30*, May 2005.

⁵⁷ Pending Case C-231/05 *Esab*.

⁵⁸ *Aktiebolaget Linden v. Skatteverket*, reported in Loyens & Loeff *EU Tax Alert No. 32*, July 2005

⁵⁹ Cited above, footnote 18. The Netherlands government was supported by the Italian, French, and UK governments, perhaps indicating that tax provisions of these countries were potentially threatened by the outcome.

⁶⁰ Cited above, footnote 18.

Austrian company on its profits and the shareholder on her dividends. The ECJ found that the difference in the tax applied to foreign and domestic dividends deterred Austrians from investing in non-Austrian companies, and inhibited the ability of such companies to raise capital in Austria. Both effects constituted restrictions on the free movement of capital.

Shortly after *Lenz*, the *Manninen*⁶¹ case confirmed the same result in respect of the Finnish dividend tax system, which provided a tax credit for dividends received from Finnish companies, but not from foreign companies. In its reporting on the *Manninen* case, the Financial Times suggested that it could represent a huge windfall for taxpayers and quoted accountants as saying the case had ‘explosive implications for the treatment of cross-border dividends’ (Brown 2004).

A challenge to the former German dividend taxation system is pending before the ECJ,⁶² even though Germany replaced its system with one which complies with EC law in 2001.

Austria, Finland, and the UK are member states which have recently changed their laws on taxation of dividends to comply with EC law, but this does not relieve them from liability to refund tax collected before the reforms, with interest equivalent to that which would be paid in respect of a refund of tax under domestic law.

5. STATE AID AND DIRECT TAXATION⁶³

TEC Article 87(1) prohibits, as ‘incompatible with the common market’ a grant of an advantage in any form, through state resources, which favours certain undertakings or certain activities if the advantage threatens to distort competition or affect intra-Community trade. While state bail-outs or direct subsidization of companies or sectors may have been the primary target of these provisions, direct (and indirect) tax incentives which favour certain companies or investors are also state aid. There are various exceptions for schemes which would otherwise be prohibited, but which may be considered by the Commission to be compatible

⁶¹ Cited above, note 10.

⁶² Pending case C-292/04 *Meilicke* discussed below. There are a number of other pending cases challenging the member states’ systems for taxing both inbound and outbound dividends. Notable among them are Case C-374/04 *Test Claimants in Class IV of the ACT Group Litigation* and Case C-446/04 *Test Claimants in the Franked Investment Income Group Litigation*, as there are obviously very significant amounts of tax in issue.

⁶³ For a more detailed discussion of direct taxation and state aid, see O’Brien (2005: 209) and the references cited therein.

with the common market in Art. 87(3) for example, for undertakings operating in economically underdeveloped or remote regions, for small companies, or for research or employee training.

In 1998 the Commission indicated that it would begin to assess member states' business taxation regimes for compliance with the prohibition on state aid in a more systematic manner, and described its policy in this area.⁶⁴ The law relating to state aid in fiscal matters was already fairly well settled, and the Court of First Instance has stated that the 1998 Commission notice accurately reflects the law.⁶⁵

A decision assessing whether a measure constitutes unlawful state aid is taken first by the Commission following an investigation. The decision of the Commission is subject to an action for annulment by the person or member state to which the decision is addressed before the Court of First Instance ('CFI') with a further appeal on a point of law to the ECJ.

Member states must notify the Commission of all new measures they plan to implement in sufficient time to allow the Commission to assess whether they constitute state aid (TEC Art 88(3)). Failure to notify the Commission results in the measure automatically being unlawful, and the member state concerned is required to recover from the beneficiaries of the aid any tax they had been relieved of by the unlawful tax incentive. The amounts can be very substantial.⁶⁶

The Commission may also review existing tax incentives which have previously been approved as not incompatible with the common market and require that they be abolished. This occurred in 1998 when the Commission decided that Ireland would have to abolish its special 10 per cent tax rate for manufacturing companies and for companies operating in the International Financial Service Centre and Shannon airport zone.⁶⁷ The special treatment had been permitted to promote Ireland's economic development, and is widely viewed as having been one of the engines of Ireland's phenomenal growth during the

⁶⁴ Notice of the Commission on the application of the state aid rules to measures relating to direct business taxation, [1998] O.J. C 384/3. At the time, both the EU and the OECD were taking action against harmful tax competition both from tax havens, and from members of these organizations which were considered to be utilizing abusive tax incentives as a means of attracting certain kinds of investment and economic activities from other members.

⁶⁵ See Joined cases T-346/99, T-347/99 and T-348/99 *Diputación Foral de Alava* [2002] ECR II – 4259 at [83].

⁶⁶ The Commission has recently ordered France Telecom to repay approximately €800 million in tax reductions it received between 1994 and 2002: Commission press release IP/04/981 July 20, 2004, and Bull.EL (2004/7-8).

⁶⁷ See Commission proposal for appropriate measures under Article 93(1) of the EC Treaty concerning the International Financial Service Centre and Shannon customs-free airport zone: [1998] O.J. C 395/8.

1990s. Ireland's response to the Commission's proposal was to establish a single general corporate tax rate of 12.5 per cent, still the lowest in the EU 25, indicating that low corporate taxes were seen as providing an economic advantage, overall, to Ireland.

While in general it is probably true that limiting the ability of member state governments to distribute state resources to particular companies or sectors should improve the government's budgetary situation, there are some aspects of the state aid rules which may have the opposite effect. First, there are numerous examples of state aid in the form of direct tax incentives that, looked at from the opposite perspective, constitute direct tax measures which discriminate on the basis of nationality or restrict the exercise of fundamental freedoms. Granting favourable tax treatment to the dividends paid by domestic companies over foreign ones is equivalent to providing an advantage to some (domestic) undertakings through state resources which is liable to affect intra-Community trade (i.e. free movement of capital).⁶⁸ Allowing a French company a tax credit against its French tax liability for expenses of research carried out in France is both a restriction on free movement of services,⁶⁹ and a form of state aid for French research companies.⁷⁰ Thus a measure which constitutes state aid may be challenged by those not entitled to benefit from it, with the result that the tax expenditure must be extended to all taxpayers (or completely abolished). It may thus turn out to be more expensive to the treasury than anticipated.

A French tax measure which has recently been the subject of state aid proceedings shows that granting a direct tax concession to some companies may be beneficial to the state's general finances.⁷¹ Favourable consolidation of asset depreciation appears to be permitted for some French companies with approval of the Minister of Finance, where the groups operations are of 'significant economic and social interest'. This implies that permission to use the favourable tax rule is conditional on the Minister receiving a quid pro quo⁷². It may constitute unlawful state aid if found to be available only to some companies (large French ones) and

⁶⁸ *Verkooijen*, footnote 18.

⁶⁹ Case C-39/04 *Laboratoires Fournier*, [2005] ECR I-2057.

⁷⁰ Case C-254/97 *Baxter* [1999] ECR I-4811.

⁷¹ State aid No C 46/2004 – Fiscal economic interest groups: tax depreciation favourable to firms that are approved by the Ministry of the Budget, [2005] O.J. C 89/6.

⁷² See 'Fiscal Favours', *The Economist*, 4 September 2004, where it is reported that Vivendi, a French based multi-national, has recently been allowed to use a beneficial tax consolidation method which complies with the requirements of the *Marks and Spencer* ruling by allowing it to combine profits and losses of all members of the corporate group. This is estimated to result in corporate tax savings of almost €4 billion over five years. In exchange, Vivendi promised to employ 2100 employees in under-developed regions of France. The Commission is investigating whether this complies with EU state aid rules: Sheppard (2005).

not others. The social security contributions of employer and employees might well exceed the corporate tax foregone.

As shown by the Irish example, a tax expenditure designed to promote economic growth may, over the longer term, operate to increase tax revenue⁷³ rather than decreasing it, allowing a member state to improve its budget balance. However, this does not protect the tax measure from being prohibited state aid. The Commission emphasizes that if the measure grants an advantage to only some businesses, and cannot benefit from a particular exemption allowed by 87(3), it will be prohibited. This forces member states to reduce their general corporate rates to stimulate growth and attract inward investment, which normally has, at least initially, a negative effect on revenue and thus budgetary stability.⁷⁴

This is essentially what several of the new members of the EU who acceded in 2004 have done.⁷⁵ Many of them have general corporate tax rates below 20 per cent, or have announced plans to cut rates to those levels or below⁷⁶. The old EU 15 had an average rate of 30.3 per cent in 2005, according to Netherlands finance ministry. Austria has cut its corporate tax rate from 34 per cent to 25 per cent effective in 2005 (Haig 2005), and the Netherlands recently announced an additional rate cut from 30 per cent to 26.9 per cent as of 2008. Both these states cited the need to remain competitive as a reason for the cuts. Member states which do not follow suit may find they lose tax revenue to lower tax jurisdictions, just as the ECJ rules they may no longer rely on CFC or thin capitalization rules to protect their tax base from erosion.

From a process perspective, the requirement to notify the Commission of new aid measures no doubt limits the flexibility of finance ministries when preparing and publicizing annual budgets. There are also instances where a measure which was originally not prohibited was amended so as to become prohibited state aid during the course of enactment into law. These types of disruptions to accurate

⁷³ In a few instances, an aid scheme has been defended as not using state resources, as its intention is to raise more revenue by attracting more activity than the total tax concessions granted. This has not been a successful argument. The Commission rejects such abstract statements of purpose, and assesses whether there has been aid at the level of each company benefiting from it. See Commission Decision 2003/86/EC on tax holidays for newly established firms in Vizcaya, [2003] O.J. L 40/11 at [45].

⁷⁴ Slovakia has actually found that its low 19 per cent 'flat tax' has resulted in increased revenues, according to *The Economist* (2005) 'Reaping the European Union Harvest', 6 January 2005.

⁷⁵ See Houlder, Vanessa (2006) 'EU tax competition drives down corporate rates', *Financial Times*, 5 April 2006, reporting on the international survey conducted by KPMG indicating that average corporate tax rates in the EU have dropped below the international average.

⁷⁶ See Ernst, Young and Zew (2004) 'Company Taxation in the New EU Member States (2nd edition)', July 2004, available at [http://www.ey.com/global/download.nsf/International/EU_Tax_2004/\\$file/EU_Tax_2004.pdf](http://www.ey.com/global/download.nsf/International/EU_Tax_2004/$file/EU_Tax_2004.pdf) at p. 39 (accessed 31 August 2005).

revenue and expenditure forecasting could affect optimal longer term budget planning.

6. QUANTIFYING THE IMPACT OF THE ECJ RULINGS

How significant are the ECJ direct tax cases for member states' budgets? The answer depends in part on the importance of direct taxation, and specifically corporation tax to a member state's overall tax revenue. This varies greatly among the EU 15, and even more among the EU 25, but it must be recognized that a relatively small proportion of EU member states' tax revenue is derived from taxation of corporate profits.⁷⁷

The amounts of back taxes, interest, and, at least potentially, compound interest and damages for which member states may be liable are not accurately quantifiable. The final bill is not in, as new cases are still be commenced, and appeals of older ones are still ongoing. The issue of how many past years' taxes are susceptible to claims for refunds is a matter of national law and so will vary among member states. It is also affected by how quickly a member state's finance ministry has recognized the vulnerability and amended its laws if member states have not publicized estimates of their liabilities.

Nevertheless, there are clear indications that member states are concerned about the impact of the ECJ's decisions on their budgets, some of which have been referred to earlier in this paper. At the Economic and Financial Affairs Council (ECOFIN) meeting of 6 and 7 June 2005, the published description of topics to be discussed included the impact on budgets of tax decisions of the ECJ (proposed by Germany). This was apparently discussed at the ECOFIN Council meetings of 17 February 2005 and 6-7 June 2005.⁷⁸

The Financial Times has recently reported that one of the objectives of the UK presidency of the EU, which commenced 1 July 2005, will be to limit the effect of the ECJ's tax rulings (Giles 2005; see also Houlder 2004). The report

⁷⁷ OECD statistics for 2002 show that corporation tax is lowest as a proportion of all tax revenue in Germany (2.9 per cent) and highest in Luxembourg (20.5 per cent) and Ireland (13.1 per cent). Corporation tax represents 8.1 per cent of UK tax revenue, and 8.8 per cent of the Netherlands' tax revenue for that year (see OECD 2004b).

⁷⁸ Commission Press Release 'Preparation of Informal Eurogroup and Council of Economics and Finance Ministers, Luxembourg 6 and 7 June', MEMO/05/193, 6 June 2005. The minutes of the 17 February meeting do not mention the discussion; the minutes of the June meeting (Council Doc 9888/05) indicate that the Ministers discussed this issue 'over lunch'.

indicates that the UK will discuss with its EU partners the possibilities for protecting national treasuries against ECJ rulings, and particularly against claims for refunds of tax collected several years in the past. Germany and the Netherlands⁷⁹ were named as among other member states supporting the UK's position.

Limiting the pecuniary effect of ECJ's rulings in all tax cases would require a revision of the TEC, which must be agreed by all twenty-five member states. It might take the form of a protocol to the TEC declaring that judgments of the ECJ on tax matters which threaten to seriously affect budgetary stability in one or more member states shall have prospective effect only, so that the member states would not be liable to refund taxes collected before a certain date. A similar result was achieved in a protocol to the Treaty of Maastricht which limited the effects of the ECJ's ruling in a case on sex discrimination in private pension plans⁸⁰, which otherwise could have had disastrous budgetary impacts for member states.

In exceptional cases, beginning with *Defrenne II*,⁸¹ the ECJ has limited the temporal effects of its judgment in various ways and circumstances, but there are no clearly established principles for limiting entitlement to tax refunds. Now that many taxpayers are claiming refunds of taxes (and member states are revising their tax laws) based on pending cases, sometimes even before the Advocate General's opinion is published, a new solution may be required. An indication that the ECJ is aware of the importance of the issue is the fact that it has recently ordered the reopening of the oral procedure, including a new Advocate General's opinion, in two key tax cases where the amounts of refunds were potentially enormous. The first case, *Banca Popolare de Cremona*,⁸² concerns an indirect tax measure, and the amounts of tax which may have been collected in contravention of EC law are very large. On 21 October 2005, after nine member state governments made requests to the Court, an order was made reopening the hearing.⁸³

⁷⁹ Giles (2005) states: 'Joop Wijn, the Dutch deputy finance minister, told the Financial Times that a principal focus would be ensuring that ECJ rulings did not give rise to backdated compensation claims by companies. 'The EU, he added, had to find a way to give the court of justice more directions.'

⁸⁰ Case C-262-88 *Barber v. Guardian Royal Exchange Assurance Group* [1990] ECR I-1889.

⁸¹ Case 43/75 [1976] ECR 445.

⁸² Pending Case C-475/03.

⁸³ Advocate General Stix-Hackl delivered her opinion on 14 March 2006 recommending that claims for reimbursement of the invalid tax for periods before the Court's judgment be barred, except those claims commenced before the date the original Advocate General in the case delivered his Opinion.

The Court has also ordered, on 7 April 2006, the reopening of the oral procedure and transfer to the Grand Chamber in the direct tax case of *Meilicke*,⁸⁴ mentioned above, which concerns the German dividend tax system. The German government has estimated its potential liability to refund tax at some five billion euros in this case. In his original opinion in the case of 10 November 2005 Advocate General Tizzano suggested that the judgment in *Meilicke* have effect from the date of the ECJ's ruling in *Verkooijen*,⁸⁵ as that was the time at which EC law on the direct taxation of dividends in these circumstances became clear. Thus tax unlawfully charged from 6 June 2000 to the date when the German government amended its law so as to comply with EC law could, in principle, be recovered. Claims for refunds commenced prior to the ruling in *Verkooijen* were not to be limited in amount to tax collected after the *Verkooijen* date. Claims brought after 6 June 2000 but before the order for reference in the *Meilicke* case was published in the Official Journal could also proceed. The huge number of claims commenced after the publicity surrounding the *Meilicke* would, if allowed to proceed, cause serious economic repercussions. The second Advocate General's opinion in *Meilicke* is still pending, as of course is the ECJ's ruling on both the merits and the temporal limitations which should apply to the judgment.

There is one other official acknowledgment by an Advocate General of the need to settle the principles applicable to direct taxation and fundamental freedoms that demands citation. In his Opinion in *Test Claimants in Class IV of the ACT Group Litigation*,⁸⁶ Advocate General Geelhoed notes the 'increasingly complicated factual and legislative context and arguments' in the field of corporate direct taxation and free movement, and states that it is an area where 'predictability and legal certainty are crucially important, so that member states can plan their budget and design their corporate tax systems on the basis of relatively reliable revenue predictions'.

Finally, it seems that the Commission is also concerned about the threat posed by tax rulings to member states' budgets. It has been reported that the Commissioner for Taxation, László Kovács, has asked an advisory committee on direct tax matters to prepare for the effects of ECJ rulings which may have serious adverse consequences for member states, and advise where harmonization measures are most necessary.⁸⁷

⁸⁴ Pending Case C-292/04.

⁸⁵ See footnote 18.

⁸⁶ Case C-374/04, Opinion of 23 February 2006 at [3].

⁸⁷ Loyens & Loeff, *EU Tax Alert No. 32*, July 2005.

7. CONCLUSION

The pressure on member states from the ECJ is reaching a critical point. Corporate tax competition is increasing among member states as rates are cut and defensive measures are ruled incompatible with EC law. At the same time, the likelihood of coordinated action to establish a harmonized corporate tax base at the EU level is diminished by enlargement due to the requirement of unanimity in the Council and the political upheaval caused by the recent rejection of the proposed Constitutional Treaty. The conditions for budgetary instability as a result of these developments are present, and in the last few months, evidence of growing concern among member states and the Commission is beginning to emerge. The question now is whether the *D Case* and *Marks and Spencer* mark a shift, however slight, in the ECJ's approach, or are isolated cases which will be confined to their particular circumstances. The willingness of the ECJ to consider imposing temporal limitations on its rulings may also indicate that it is aware of the significance of the tax jurisprudence in the broader context of member states' budgetary equilibrium.

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