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## Theoretical Models of Fiscal Policies in the Euroland

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

Stefan Collignon



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## **Abstract**

Due to collective action problems, the Eurozone is stuck in a sub-optimal macro-policy mix of too expansionary fiscal policy and too restrictive monetary policy. Although the Lisbon Strategy pays lip service to macro-economic policy coordination, no mechanisms, institutions or effective rules are established in order to overcome the collective action problem. Empirically, the failure is demonstrated by comparing the Eurozone policy mix with the US policy mix and attributing it to the low investment performance which resulted in low average GDP growth and low average productivity growth - contrary to the aims of the Lisbon Strategy to make the EU the world's most dynamic economy. The paper also argues that in order to overcome these difficulties, a proper government for the European Union is needed. More delegation to the European level is only legitimate if European citizens can exert their democratic rights.

## **Keywords**

Democracy - Economic growth - European Central Bank - Fiscal policy - Legitimacy  
- Policy coordination



## Introduction

In March 2000 at the Lisbon European Council, the heads of State and government promised to make the EU by 2010 “the most dynamic and competitive knowledge-based economy in the world, capable of sustainable economic growth with more and better jobs and greater social cohesion, and respect for the environment”. If this statement was meant to inspire enthusiasm, it has failed. Over-commitment and unachievable goals have ridiculed European policy makers. Despite desirable objectives, national compliance with the Lisbon Strategy remains poor. The European Commission (2005: 4) has explained this underperformance by “a policy agenda, which has become overloaded, failing coordination and sometimes conflicting priorities.” Yet, the official mid-term review did not explain the reasons for this coordination failure. It has exhorted governments “to do more reforms”, but few member states seem capable of achieving them and when they do so, the results are not as expected.

In 2005, five years after Lisbon and midway to the goal, the Commission has proclaimed a “new departure” by focusing on a limited number of “key actions that promise the highest and most immediate dividends” (Barroso 2005), namely investment, innovation and jobs. The new focus was primarily on the supply-side. Ironically, as soon as this was declared, a mix of favorable demand for exports and domestic demand due to higher wages and improved consumer confidence after the German elections pulled the Euro area out of its stagnation (European Commission 2006). The question is, whether the growth spurt will be sustainable and for how long. Economic reforms under the “new” Lisbon Strategy are intended to improve research and development, labour market flexibility and capital market integration. No doubt this would improve Europe’s productive capacities. However, experience from the past has shown that, contrary to the American experience under Clinton, a favorable macroeconomic environment is in the EU usually short-lived. Two noticeable holes in the “new” Strategy may endanger the recent growth performance: the absence of a macroeconomic policy strategy and the issue of governance. In fact, the new Lisbon Strategy is “less, of the same.” It is *less*, because macroeconomic management and social cohesion have been dropped from the agenda. It is the *same*, because it does not address Europe’s institutional imbalances. I will show that the EU’s disappointing performance is due to a collective action problem, which applies to both, supply side reforms and macroeconomic management. Europe’s economic difficulties cannot be separated from constitutional questions. The problem is “governing without government” (Rosenau 1992; Rhodes 1996), or more precisely “governance with many governments.” I will first examine where the Lisbon Strategy is failing in its present arrangement, and then focus on the flawed macroeconomic framework, which requires constitutional reforms.

## Where the Lisbon Strategy is failing

The Lisbon Strategy must be seen in its political context, which has dramatically changed since its inception and has shifted the emphasis on economic supply-side reforms. But even these reforms are not forthcoming because of collective action problems. The result is a disappointing performance.

## The political context

Europe's Lisbon Strategy was inspired by the strong economic growth in the United States in the late 1990s. The Clinton administration had followed advice from the Federal Reserve Bank and consolidated public finances to bring interest rates down. The longest economic upswing in US history followed. The investment share in US GDP rose from 16 percent in 1992 to 21 percent in 2000 and unemployment fell to 4 percent, the lowest level since the 1960s. New investment incorporated technological innovation in ITC industries raising productivity after a long period of stagnation. This was the envied model of America's "new economy." By contrast in Europe, growth and investment were low, unemployment high. The investment share, which stood at 27 percent in the 1960s and early 1970s, had fallen to 20 percent by 1996. Because investment was low, technological progress was not incorporated to the same degree as in the USA and human capital seemed to be deficient. In the late 1990s a sense of stagnation was all-pervasive.

The shift to a "new" economy in America reflected a policy choice. Before 1992, the "old" US economy had also been stagnating, with growth of real investment negative between 1985 and 1992 and wide-spread criticism of the American economic model.<sup>1</sup> The US economy was deregulated in the early 1980's, but economic growth only came in the 1990s after macroeconomic policies changed. The Republican administrations of Reagan and Bush had maintained high fiscal deficits and interest rates; under Clinton, both came down - with the deficit even turning into a surplus. US real long term interest rates were one percentage point higher in 1985-91 than the synthetic interest rate for Euroland, but over 1992-2004 they were 19 base points lower. This change in macroeconomic policy was instrumental in turning the US economy around.

The EU's unsatisfactory performance is not usually explained in terms of policy choices, but by structural factors, particularly in the labor market. It has often been affirmed that *Eurosclerosis* due to protective national regulation and the insufficient integration of markets has been impeding economic growth in the EU. Yet, the rapid reversal of fortunes in the USA indicates that Europe's problems may depend more on policies than on institutions and structures. The Single Market has already removed many obstacles and was largely completed by the early 1990s. Nevertheless, the following decade was marked by stagnation and unemployment remained stubbornly high.

In response to this situation, different European Councils have doubled up on structural reforms by setting up so-called reform-"processes" without addressing the difficulty of conducting macroeconomic policy in the Euro area. The *Luxembourg process* set an agenda for labour market reforms in 1997. Procedures for the complete unification of the goods and capital market were put into place in *Cardiff* in 1998. Only in 1999 at the *Cologne* Council did macroeconomics appear on the European agenda by setting up a dialogue on the policy mix between wage bargainers, finance ministers and the European Central Bank (ECB). But these "processes" did not

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<sup>1</sup> In the 1980s Japan and Germany were considered to be the superior model, given that these countries seemed to favour long term relations, while the US system was seen as too short-term oriented. In the 1990s this view was inverted; now flexibility was thought to be the trump card.

produce the expected results. In fact, they were called *processes* because the European heads of State and government could not agree on substantial policies.

The Lisbon Strategy in 2000 was an attempt to overcome these difficulties. No longer a “process”, it was meant “to load substance into the empty lorries of Cardiff, Luxembourg and Cologne”.<sup>2</sup> The Lisbon Strategy sought to match supply-side reforms with responsible demand management in order to increase growth. Higher welfare necessitated higher productivity and therefore innovation and knowledge to improve potential output. Formally, the Strategy addressed four policy *areas*: (1) Reforms to create a knowledge society, intended to help Europe catching up with the “new economy” and improve productivity. (2) Optimal macroeconomic policies to ensure that the higher potential output would effectively be absorbed by demand in product markets without creating inflationary tensions. (3) Completing the integration of Europe’s capital market to increase investment, especially by raising venture capital for innovation in small and medium-sized companies. (4) Reformulating the European social model, not by dismantling the welfare state, but by putting social inclusion first and empowering governments to deal with the challenges of globalization and an aging society.

The Lisbon agenda reflected the dominance of centre-left governments in Europe at the time and their commitment to macroeconomic policy. Portugal’s Prime Minister Antonio Guterres had first designed its basic objectives in a working group of the European Socialist Party (ESP) aimed at reducing unemployment (Kulahci 2002). A year later he used the EU presidency to put it into practice.

The focus of the Lisbon Strategy was economic growth. The creation of a “Knowledge society” aimed at improving the supply side. But given that job creation requires actual GDP to grow faster than productivity (Collignon 2002), macroeconomic policy was considered indispensable for creating higher employment, consolidating public finances and releasing resources for Europe’s social model. The European Commission had previously calculated that the EU would reach full employment if GDP would grow at 3 percent for one decade. The Portuguese EU-presidency now proposed the idea of *setting a 3 percent growth rate as a numerical policy target for Euroland*. Given that the European Central Bank (ECB) had defined price stability as a rate of inflation “below, but close to 2,” it seems reasonable that the European Council could also set its growth target numerically. This approach was justified by the Treaty on European Union. The ECB was committed to price stability as its “primary objective” (art. 105.2), but according to art. 2 of the Treaty on European Union, it also was obliged “to promote throughout the Community a harmonious, balanced and sustainable development of economic activities, a high level of employment and of social protection, equality between men and women, sustainable and non-inflationary growth, a high degree of competitiveness and convergence of economic performance,(...)”, provided price stability was assured. Thus, by specifying the numerical content of the Treaty article 2, the European Council would define clearly what kind of growth rate the ECB ought to support when price stability was achieved. For example, the ECB should have taken the more ambitious growth objective of 3

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<sup>2</sup> This was the formulation frequently used by policy makers. At the time, the author was an active participant in the Guterres ESP-group and in charge of the Lisbon inter-ministerial policy coordination in the German government. For the theoretical foundation of the macroeconomic strategy behind the Cologne process and Lisbon Strategy, see Collignon (1999).

percent, rather than 2.5 percent, when setting the reference values for monetary aggregates. The numerical target for economic growth would also have strengthened the voice of finance ministers at the informal meetings of the Euro-group and improved the democratic legitimacy of European policy making. It might have prevented some of the ECB-bashers in later years. Furthermore with growth at 3 and inflation at 2 percent, and with budget deficits capped at maximal 3 percent, the debt/GDP ratio would have stabilized below 60 percent, ensuring the long run sustainability of public finance. But in the end the option of fixing a numerical growth target was not adopted at Lisbon, because a member from an opt-out country insisted that more ambitious objectives would unleash entrepreneurial creativity. The 3 percent target was replaced by the goal of becoming “the world’s most dynamic and competitive economy.” This formulation effectively prevented the institutional anchoring of macroeconomic policy into the Lisbon Strategy.

In the following years, right-wing governments swept back into power. The emphasis on macroeconomic policy and social inclusion was lost and a more narrow supply-side approach became dominant. With the growing political heterogeneity in the Council, agreement on binding policies became even more difficult. The Lisbon Strategy had to rely on the “Open Method of Coordination” with best-practice comparisons and peer pressure as instruments.<sup>3</sup> With this method it was not possible to conduct a coherent set of structural supply side reforms and a growth-supporting macroeconomic frame work. Not surprisingly, the Lisbon Strategy never really took off.

### **The “open method of coordination” and the collective action problem**

The repeated coordination failure in economic policy has institutional causes. It is a consequence of collective action problems, which emerge when autonomous governments seek to maximize collective utilities in isolated constituencies. Governments are constrained by national debates and by the partial interests articulated within their home constituencies.<sup>4</sup> In order to get (re-)elected, political leaders and parties must attempt to maximize the utility of their national constituency. As long as a European government does not exist, there is no European constituency and therefore no European-wide deliberation on collective policy preferences. Factional interests of national constituencies will then prevent the realization of the collective utility optimum, as Madison has already shown more

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<sup>3</sup> Historically, the “open method of coordination” (OMC) was an accident; it came about because several governments, and in particular the German chancellor, resisted having “their hands tied”, let alone delegating power to the Commission. Guterres therefore sought to enroll member states into an open intergovernmental process of policy coordination, where “open” meant “unconstrained”. In essence, the OMC is equivalent to respecting member states’ veto power. Nevertheless, governments were urged to commit to specific common policy objectives, while implementation was left to them. To safeguard against uncooperative behaviour, multilateral surveillance by the Commission and peer pressure through “naming and shaming” of non-performers was considered sufficient. The OMC is therefore a stronger form of policy coordination than simple voluntary action, but it suffers from the same dilemma as previous coordination attempts: incentives for free-riding hamper unified action necessary for the provision of exclusive European collective goods.

<sup>4</sup> By partial interests, I mean collective preferences that dominate some groups, but are in contradiction with the general preferences of all European citizens. Partial interests are therefore welfare lowering. The general welfare could be optimized, if they all citizens participated in the policy debate on issues that concern them all together.



than 200 years ago.<sup>5</sup> This is exactly the problem in the EU. Policies are shaped by negotiations in a “two-level-game” (Putnam 1988), where governments take the preferences within their constituency as given and negotiate compromises at the lowest common denominator in the European Council. The resulting Nash-equilibrium does not optimize welfare. This is different from a “normal” democracy, where formulating common policy preferences requires a deliberation process, which takes into account the interests of all European citizens and not only those of national factions. In the EU such democratic deliberation is institutionally impossible. The idea of “policy processes”, the “Open Method of Coordination”, etc. therefore expressed the less ambitious objective of going through a deliberation process amongst policy-making elites, so that governments would ultimately find solutions acceptable to all. However, this idea has underestimated the importance of vested interests articulated in national politics. Changing policy preferences through bureaucratic deliberation only works for technocratic issues, such as setting technical regulations for the single market. In areas of high politics, which is submitted to universal suffrage in national constituencies, the emergence of consensual policy preferences can take a very long time.<sup>6</sup> Europe’s economic governance therefore has become a mix of cheap talk about reforms and gridlock in decision-making.

In essence, the failure of the Lisbon Strategy is due to a collective action problem: Countries find it in their national interest *not* to stick to policies, which would maximize the overall collective European welfare, as long as everyone else pursued them. But because everyone has the same incentives, none will make the efforts necessary for achieving the common interest.<sup>7</sup> Why would national governments agree to European policies that might constrain their actions at home? The somewhat naïve Europhile answer is that the existence of positive policy externalities creates incentives to cooperate. As the Kok-report (2004) formulated: “Actions by any one Member State (...) would be all the more effective if all other Member States acted in concert; a jointly created economic tide would be even more powerful in its capacity to lift every European boat. The more the EU could develop its knowledge and market opening initiatives in tandem, the stronger and more competitive each Member State’s economy would be.” Along these lines, the European Commission has also been propagating for years that “massive potential gains” were to be reaped from wider and deeper integration, while “non-Europe” was a costly waste of resources. But the question remains, why these gains are not realised despite such obvious advantages for all. The answer is not simply lack of focus or insufficient support, as the Commission (2005: 5) claims. It is rooted in the structure of political incentives.

The theory of collective action has clearly established that the existence of potential positive spillover effects is not enough to ensure cooperative behaviour (Olson 1971). Collective action problems are caused by externalities that provide incentives for non-cooperative behavior. If the costs and benefits of actions are not properly matched for

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<sup>5</sup> See Federalist Paper no. 9 and 10 in: Hamilton, Jay, Madison (2001).

<sup>6</sup> For monetary policy, e.g., it took three decades.

<sup>7</sup> For a more extensive discussion see Collignon (2003b). Jaquet and Pisani-Ferri (2001) or Buti et al. (1998) have argued that the answer to collective action problems in fiscal policy was the Stability and Growth Pact. However, this argument is based on the assumption that “member states are at the same time willing to cooperate and reluctant to transfer further national sovereignty” (Jaquet and Pisani-Ferri 2001: 4). Yet, the whole point of collective action problems is that nation states are *not* willing to cooperate because they obtain higher benefits by not doing so.

individual actors, cooperation failure is the result. These externalities can be linked to different types of public goods. *Inclusive public goods*, sometimes called club goods, are characterised by positive externalities as more members participate in a group. Because one can impose restrictions on access to the club, every individual member can be obliged to make the necessary efforts for the realisation of the common benefits. Thus, inclusive goods provide incentives for successful voluntary cooperation between independent utility maximising actors. It is, however, possible that asymmetric information could lock partners into suboptimal equilibria (prisoner dilemma). Procedures for improving the information flow are then required, possibly in the form of an independent and impartial authority. The “regulatory mechanism” by which public goods are provided without formal and central authority is therefore dependent on the nature of externalities. A policy regime that allows the efficient provisions of inclusive public goods on the basis of voluntary cooperation has been called “governance without government” (Rosenau 1992; Rhodes 1996).

For along time, European integration has thrived in the domain of inclusive public goods. The existence of the European Commission has ensured that information asymmetries were overcome so that everyone knew what action was required. For example, successful political cooperation has created the single market in order to engender economies of scale. Network projects like the Galileo satellite navigation system or the Airbus project, provide high benefits from cooperation and the possibility of reaping them is clearly allocated to each contributing participant.<sup>8</sup> Another typical club good phenomenon is participation in European monetary union (EMU), which induced the convergence of macroeconomic policies, clearly a public good. The Maastricht criteria helped create low inflation, because (nearly) everyone wanted to share in the benefits from monetary union and the possibility of being excluded made governments comply. Convergence policies were therefore “owned” by member states. The role of the Commission consisted in monitoring the process and overcoming information asymmetries to prevent blockages. Hence, the logic of inclusive public goods makes successful voluntary cooperation among governments possible, while the Commission has to provide formal procedures to facilitate the flow of information.

With the successful convergence to the Maastricht criteria as a model, the designers of the Lisbon Strategy thought that a list of structural indicators with clear goals and objectives for each member state would accelerate reforms, release synergies and ameliorate the EU’s performance. However, the logic of self-sustained policy convergence does not work for *exclusive public goods*, which are also called common resource goods. Here it is impossible to prevent access to the consumption of the collective goods for any member of the group and therefore it is hard, if not impossible, to make them pay for the cost of producing them. Exclusive public goods therefore create incentives for free-riding.<sup>9</sup> A single member could benefit by deviating from the Strategy pursued by everyone else. As a consequence, nobody will wish to conform and voluntary cooperation cannot provide exclusive public goods optimally. The resulting collective action problem is known as “the tragedy of the commons” (Hardin 1968). It can explain many aspects of the disappointing

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<sup>8</sup> Nevertheless, the recent Airbus difficulties show that a club may still encounter difficulties in the provision of collective goods if its management is bad.

<sup>9</sup> The common resource goods are called exclusive because the members of the club will want to keep new members out, as this would reduce their benefits.

performance of the Lisbon process, because the intergovernmental governance with many national actors has no mechanism for coordinating the cooperative behaviour needed to provide exclusive goods.

As European integration has deepened in recent decades, the range of exclusive public goods has increased. In monetary union, most macroeconomic policy variables, such as inflation, nominal and real interest rates, exchange rates, economic growth and employment policies have become exclusive public goods. All members consume these goods collectively, but Europe's *governance with many governments* creates incentives for individual member states to free-ride on others. It can be shown that the incentive problems caused by the exclusive nature of public goods increase with the size of the EU.<sup>10</sup> The free-riding problem applies to supply-side reforms as well as to macroeconomic policy. For example, member states are frequently criticized for not implementing EU legislation.<sup>11</sup> The reason for the implementation failure can be a collective action problem: Although integrated production structures and supply chains would improve Europe's competitiveness in the world and are therefore in the interest of all member states, deviating behaviour by individual governments may yield partially higher benefits: if everyone else is liberalizing markets, it may be advantageous for individual countries to keep restrictions in place at least temporarily when this allows gaining uncontested market power in the larger single market.<sup>12</sup> Thus, each country has an incentive to wait with its own reforms, while pushing others to do them soon.

The problem is even more severe for macroeconomic policy because of flawed institutional arrangements. Fiscal policy is permanently hampered by coordination failure, because capital funds in EMU are a common resource good and interest rates are their scarcity price. Given that it must maintain price stability, the ECB has to restrain the provision of liquidity, which is the "common resource" in the financial system. But access to liquidity in the capital market is free for all. Higher structural public deficits will therefore, *ceteris paribus*, increase equilibrium interest rates and appreciate exchanges. This will lower economic growth. Recognizing this problem, the Stability and Growth Pact (SGP) demands the balancing of cyclically adjusted budgets. Interest rates would then be low, but at low rates it is advantageous for each member state to borrow money rather than to incur the political cost of fiscal consolidation. Hence, there exists an incentive for individual governments not to respect the Pact, while publicly insisting that everyone else should. Not surprisingly, structural deficits are not "in balance" (they are above 2 percent of GDP for the whole of Euroland and even above 3 percent for France, Germany, Italy, Portugal and Greece, see Figure 1). After the aggressive consolidation before 1999, structural deficits have deteriorated until 2002, while long-term interest rates remained high - despite the negative growth shocks in 2001 and 2002. Thus, consolidation fatigue rather than excessively tight monetary policy has kept interest rates from falling more than they did. I will discuss this claim in greater depth in the second part of this paper.

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<sup>10</sup> For a full elaboration of this argument and its underlying theory, see Collignon (2003a), Annex 2.

<sup>11</sup> The Commission (2005: 8) writes: "In a number of Member States, key markets like telecoms, energy and transport are open only on paper - long after the expiry of the deadlines to which those Member States have signed up."

<sup>12</sup> A sufficient condition for this logic to be valid is the existence of increasing returns to scale as emphasized by the New Trade Theory.

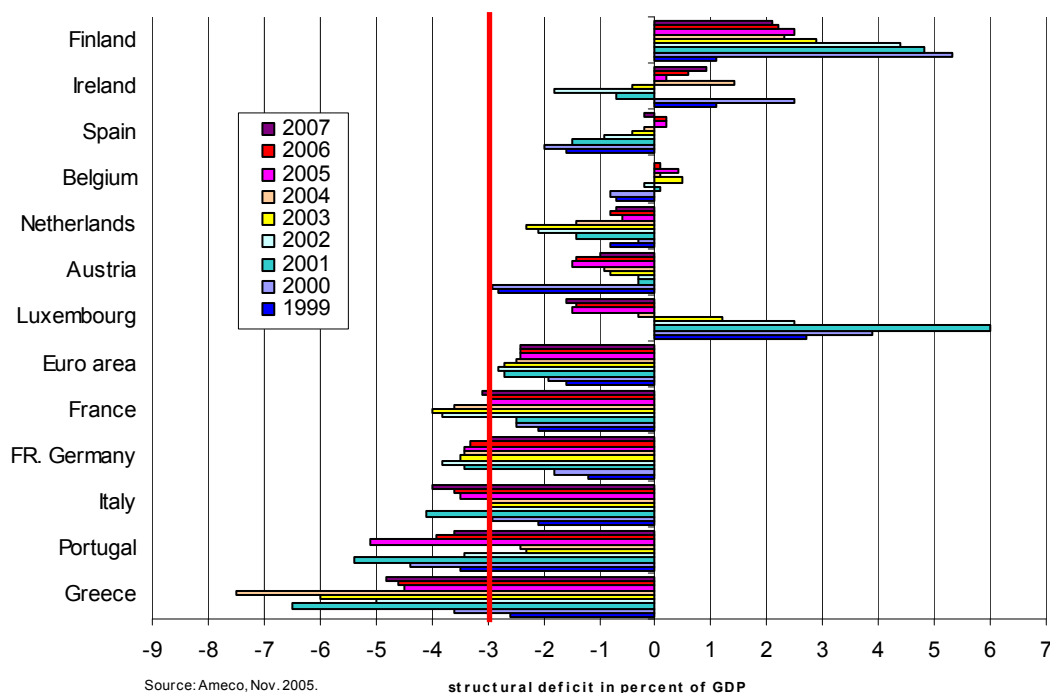


Figure 1. Structural Deficit (based on potential GDP) in Euroland 1999-2007

The correct policy response would be either hard and constraining binding rules or policy delegation to a European institution in order to ensure a coherent and unified policy in the interest of the Union. Especially, when there is some need for discretionary policies, exclusive public goods require the governance of a government (Collignon 2003b). But delegating macroeconomic competences to a European institution poses a problem of legitimacy. Modern democracies are founded on the principle of “No taxation without representation”. This must imply that citizens have some control over fiscal policy through elections. But if they cannot elect a European government, they only have the national channel for control. Hence fiscal policy is confronted by a dilemma: either national parliaments make budgets and are tempted by free-riding on others, or European rules are imposed on national policies, thereby hollowing out democratic processes. Decentralizing decision-making to the nation state according to the subsidiarity principle reduces output-legitimacy; more centralization to increase technocratic efficiency reduces input-legitimacy. The only solution is more democracy at the European level, so that the input by citizens determines the output they prefer.

It is now increasingly recognised that the economic governance of the EU has remained suboptimal due to inefficiencies, lack of credibility and eroding legitimacy. Unfortunately the logic underlying this failure is not. In its Communication to the Spring European Council, the Commission (2005) emphasised the need to create “political ownership” for the Lisbon goals. But once more, this was cheap talk. Ownership is not established by “streamlining existing guidelines” and by appointing

“Mr. or Ms. Lisbon.” Ownership implies property rights. Who is to be the owner of European policies? Governments or the citizens? Ownership means rights to limit access and exclude non-performers. This is precisely how a modern democracy works: it gives citizens the right to select and reject governments as their agents. Ownership for Lisbon would imply the sovereignty of citizens and a proper European democracy. Europe’s economic governance needs to be re-thought.

## A disappointing performance: Comparing Euroland to the USA

Has the Lisbon Strategy made a difference? Progress should be measured against the headline objective of a “dynamic economy.”<sup>13</sup> The result is disappointing as shown per capita income growth in Figure 2. Instead of increasing in the 6 years following the Lisbon Council compared to the performance over the previous 6 years, it actually fell. Only in the six less developed new member states and Greece was it higher. This is the opposite of what Lisbon sought to achieve. Although growth has also slowed down in the United States under George W. Bush, in 16 EU countries out of 25 – including some of the biggest member states – per capita growth was less than in the USA. Only Sweden, Finland, Poland, Luxemburg, Ireland and Cyprus experienced higher growth. Interestingly, the EU25 as a whole does not perform dramatically different from the US; the problem is the Euro-area, where growth has been lagging significantly behind the American economy. The US growth rate is nearly 50 percent higher than Euroland’s.

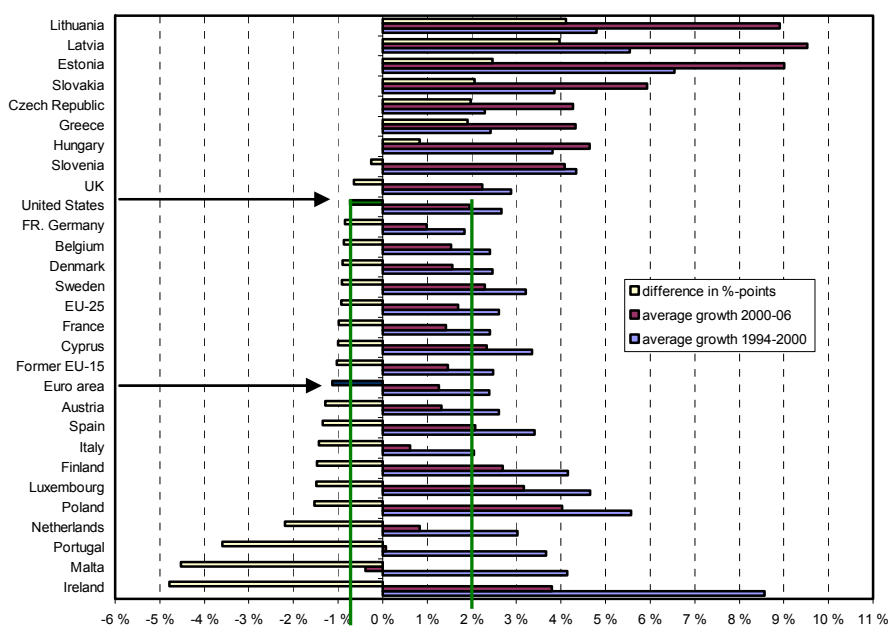


Figure 2. Average per capita Growth Rates and Differentials 2000-2006 vs. 1994-2000

How can the slow growth in Euroland be explained? Standard theory tells us that it can be decomposed into the growth rates for employment and for labour productivity. Given that the Lisbon Strategy seeks structural improvements, we are

<sup>13</sup> All figures in this paper refer to the European Commission’s AMECO database, unless otherwise specified.

less interested in the short term fluctuations and focus on the long term trends. Figure 3 therefore shows employment growth trends in the Euro-area and the USA smoothed by a Hodrick-Prescott filter. Employment growth in America has had a downward trend since the 1970s, falling by more than half from over 2.1 to 0.9 percent. In Europe, we notice the low growth rate in the 1960s and 80s,<sup>14</sup> a clear increase in the second half of the 1990s and stabilization above 1 percent since then. Yet, in recent years the contribution from employment to growth has been higher in Europe than in the US. This is surprising, given that the labour market is often blamed for Europe's bad performance.

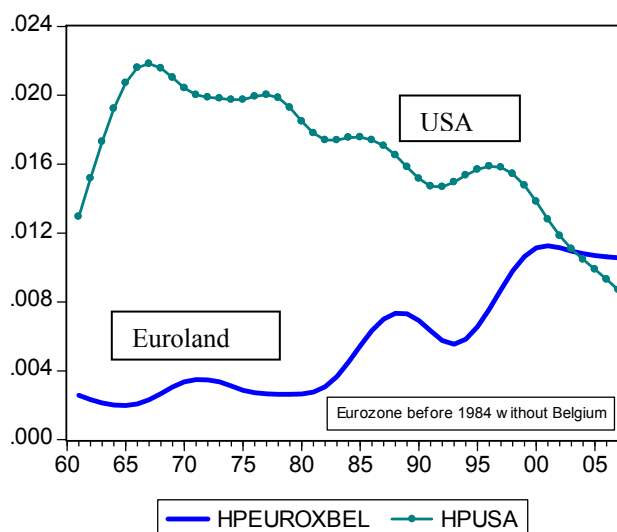


Figure 3. Employment Growth Trends

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

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

Total factor productivity in the USA has slowed down in the 1960s and 70s, but gradually improved since the early 1990s. In Europe it accelerated in the 1980s when the single market was put in place, but it fell back again in the 1990s. See Figure 5. There are no indications that the Lisbon Council has made any difference to this development, although it may have slowed down the deceleration.

<sup>14</sup> The Euroland time series is without Belgium before 1985.

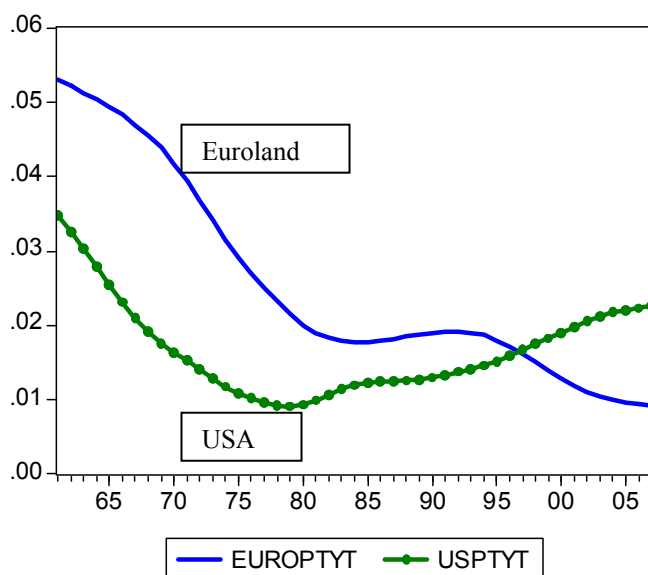


Figure 4. Labour Productivity Trends

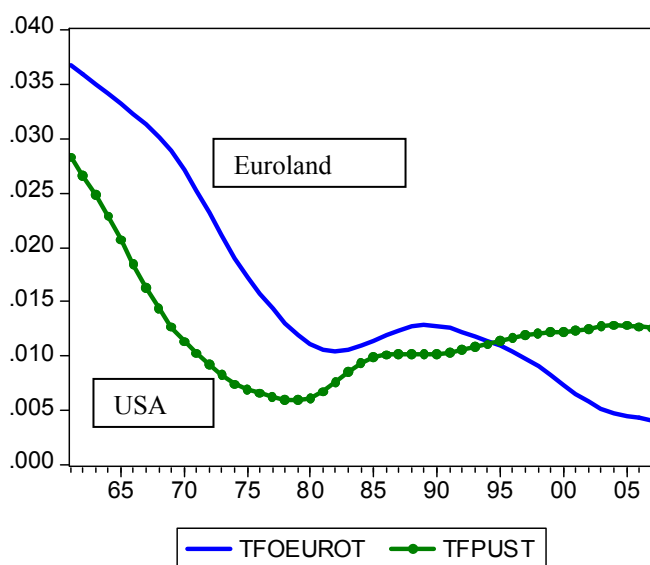


Figure 5. Total Factor Productivity Growth Trends

As is well known, growth in total-factor productivity represents output growth not accounted for by changes in inputs. It is therefore dependent on a wide range of qualitative factors, such as technological innovation, learning, social regulation etc. Europe's low performance is usually attributed to these factors and this is where the supply-side agenda of Lisbon has a role to play. For example, Kok (2004:12) argues that the US were leaders in technical innovation, accounting for 74 percent of top 300 IT companies and 46 percent of top 300 firms ranked by R & D spending, while Europe was falling behind. However, while there is truth in this claim, as it would appear from Figure 5, one must not forget that innovation, knowledge, technology

and skills must be incorporated into the stock of human and physical capital. Without investment, modern technology remains an abstract dream.

Figure 6 shows the trend performance of capital deepening. Here we find the most dramatic difference between Euroland and the United States. The US economy has gone through a process of rapid capital deepening since the early 1990s, beating all historic records; in Europe it is falling. Thus, Europe's problem is low investment.

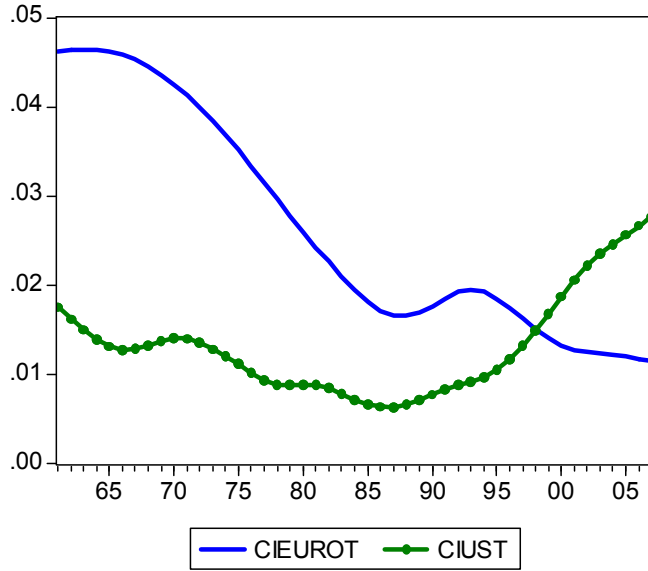


Figure 6. Capital Deepening Trends

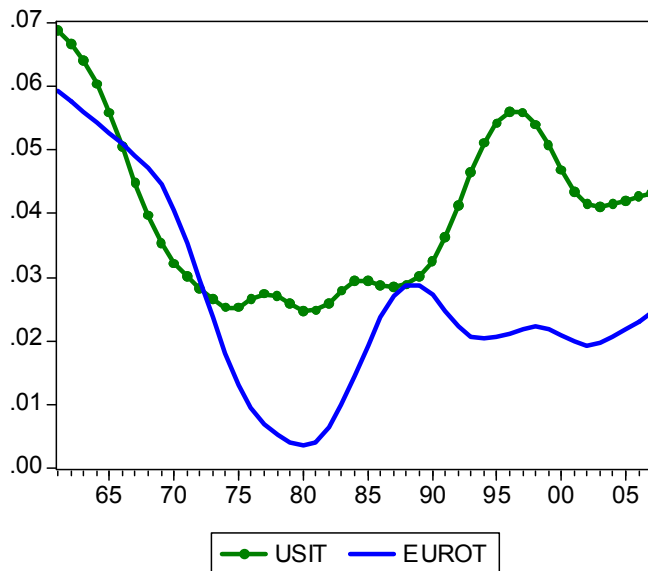


Figure 7. Gross Investment Trend Growth



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

The question is then: why is the rate of investment so low in Euroland? While microeconomic factors are surely important at the firm level, aggregate investment must be related to the profits entrepreneurs expect to make in their different markets. This is where aggregate demand – and therefore macroeconomics – matter.

## **The flawed macroeconomic and institutional framework**

If Europe wants to become “one of the most dynamic economies in the world,” it will have to improve its macroeconomic management. The policy debate on macroeconomics frequently focuses on short term micro-management, particularly the role of monetary and fiscal policy in minimizing output volatility and stabilizing the business cycle. However, the fiscal and monetary policy mix has also important implications for long-term economic growth. Critics have often accused the European Central Bank of being too restrictive and thereby impeding investment and growth. I will show that this argument misses the more important coordination failure resulting from the flawed institutional set-up for fiscal policy. An improved macroeconomic framework would require substantial institutional reforms in Europe.

## **Macroeconomic stability and investment**

How should we measure the impact of the monetary/fiscal policy mix on the growth rate? Conventional econometric models of regressing monetary and fiscal variables on output have produced ambivalent evidence.<sup>15</sup> In particular, disentangling short term and long term effects is difficult. I will therefore attempt a different approach.

Supply-side reforms and macroeconomic management are the two major factors determining investment. Structural reforms can improve labour productivity and the elasticity of labour supply, thereby improving the potential rate of growth. But actual growth will only accelerate if aggregate demand stimulates investment. Firms create jobs when they see opportunities for profit. Lowering labour costs and implementing structural reforms may be a necessary for the competitiveness in international trade, but domestic demand remains the key to the overall economic performance. Take the UK. While supply-side reforms under Thatcher and Major have revolutionised British society, GDP in Britain has increased on average 2.08 percent between 1979 and 1996, hardly more than in Mitterrand’s socialist France, where it grew at 2.05 percent per annum. With Labour’s new macroeconomic framework introduced in 1996, UK GDP increased on average by 2.68 after 1997, compared to 2.08 percent in France. The reason was hardly that France reformed the supply side less than Britain; between 1999 and 2006, domestic demand contributed 3.1 percent to U.K. growth and 1.8 percent in France; foreign trade subtracted 0.5 percent in the UK, and only 0.3 percent

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<sup>15</sup> See for example Gros and Hobza (2001). A remarkable exception is Aghion and Howitt (2005).

in France. Investment contributed 0.55 percent in Britain and 0.69 percent in France. Or look at Germany. Under the Schröder government, an aggressive reform agenda has reduced unit labour costs by 10 percentage points below the Euroland average, far below any other country, but growth has remained elusive. While German exports exceeded those of all other countries in the world, GDP grew only by 1.1 percent p.a. from 1999 to 2006, and 1.3 percent p.a. in the 7 years before. Under Schröder domestic demand contributed only 0.46 percent to growth, foreign trade 0.76.<sup>16</sup> Economic growth returned after consumer confidence was established after the German elections and wage settlements became more accommodating.

A widely believed proposition asserts that macroeconomic management does no longer work in the age of globalisation. This is wrong. After all, the USA or the UK also live in a globalized world. The share of the EU15 non-tradable value added is still above 43 percent and may be even larger.<sup>17</sup> Hence, there is a significant part of Europe's economy where profits depend exclusively on domestic demand. Comparing the two biggest economies in the world, domestic demand has contributed 3.5 percent to growth in the USA, but only 1.9 percent in Euroland. Furthermore, macroeconomic management may also influence foreign demand through the exchange rate. What is needed to stimulate investment is therefore a policy where the interaction of monetary, fiscal and wage developments creates the incentive for firms to exploit profitable market opportunities. These incentives require returns on real investment that are higher than interest rates and a framework of stability that reduces the risk premium on investment due to uncertain expectations.

During the 1970s, '80s, and '90s, Europe has suffered from monetary instability that followed the breakdown of Bretton Woods international system. With the creation of monetary union, Euroland has regained monetary stability, but it is still uncertain whether it can achieve a policy mix capable of sustaining accelerated capital accumulation, growth and higher employment. The first few years of EMU achieved a positive policy mix with historically unprecedented job creation (2.3 million in 1999, 2.4 million in 2000, 1.9 million in 2001, but only 280 thousand in 2003), although the experience was too short to make a significant impact on unemployment rates. We need to understand why. There are two possibilities: (1) high volatility due to macroeconomic instability had deterred investment and created excess savings, or (2) the steady macroeconomic environment had not encouraged investment because equilibrium interest rates are too high when compared to achievable rates of return on investment. In this section we focus on instability, in the next on the steady state.

When macroeconomic policy fails to stabilise shocks, the increased uncertainty will lead economic actors to ask for higher risk premia on the return on capital and this will lower investment. Therefore, stability of the macroeconomic environment matters for investment. If macroeconomic uncertainty can be modelled as the volatility (i.e. the conditional variance) of the growth rate of investment, we would expect a negative relation between uncertainty and the growth rate of investment (Collignon 2002; Aghion and Howitt 2005). The expected rate of investment would be a decreasing function of the conditional variance and the coefficient would measure the sensitivity of aggregate real investment to uncertainty. The time-varying equilibrium

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<sup>16</sup> Calculations from European Commission, AMECO, 2006, code CVGD.

<sup>17</sup> I assume industry and 50 percent of services to be tradables, and the other 50 percent of services plus agriculture and construction industry to be non-tradables. Data from European Commission AMECO.

investment rate can be measured by an ARCH-M model (Enders 2004), where the expected growth rate of the capital stock depends on the volatility of investment, measured by the weighted sum of past squared surprises. In other words, firms feel uncertain about investment prospects to the degree that shocks in previous periods affect this period's market conditions and on their experience of how much they have misinterpreted market conditions in the past. Table 1 gives the results for Euroland and the United States.<sup>18</sup>

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

<p>Estimation Equation:  =====</p> <p>Investment = C(1)*GARCH + C(2)</p> <p>GARCH = C(3) + C(4)*RESID(-1)^2 + C(5)*GARCH(-1)</p> <p>The RESID(-1)^2 term describes news about volatility from the previous period, measured as the lag of the squared residual from the mean equation  The GARCH(-1) term is last period's forecast variance</p> <p><u>Estimated Coefficients for Euroland:</u></p> <p>EUROinvest = -0.272*GARCH + 0.0079</p> <p>GARCH = 0.0001 + 0.438*RESID(-1)^2 + 0.326* RESID(-2)^2</p> <p><u>Estimated Coefficients for USA:</u></p> <p>USinvest = -0.342*GARCH + 0.019</p> <p>GARCH = -1.31E-07 + 0.281*RESID(-1)^2 - 0.563 Resid(-2)12 - 0.159 Resid(-3)12 + 0.935*GARCH(-1)</p>
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As expected, macroeconomic uncertainty (GARCH) reduces autonomous investment C(2). The rate of investment responds negatively to macroeconomic instability in both economies. Interestingly, the coefficient that measures the elasticity of this response is not dramatically different between the American and Euro-economy. It is -0.34 for the US, -0.27 for Euroland. However, the dynamics of uncertainty are different. In Europe uncertainty is strongly affected by cumulative expectation surprises in the last two quarters. Europeans seem to believe that when things are bad, they will get even worse. By contrast, in the USA, past surprises partially compensate each other. This may reflect optimism under conditions of more "flexible" market structures or more activist macro-policies in the United States. However, the net effect of these expectation errors is long lasting in its impact on today's uncertainty. Thus, greater macroeconomic stability is likely to have a more persistent positive impact on investment. This may in part explain the remarkable performance of the US-economy during the Greenspan years. But it is an interesting fact that whatever causes uncertainty in economic expectations, the reaction by firms

<sup>18</sup> See also technical annex.

for undertaking real investment is fairly similar on either side of the Atlantic, with Europeans being slightly less responsive than Americans.

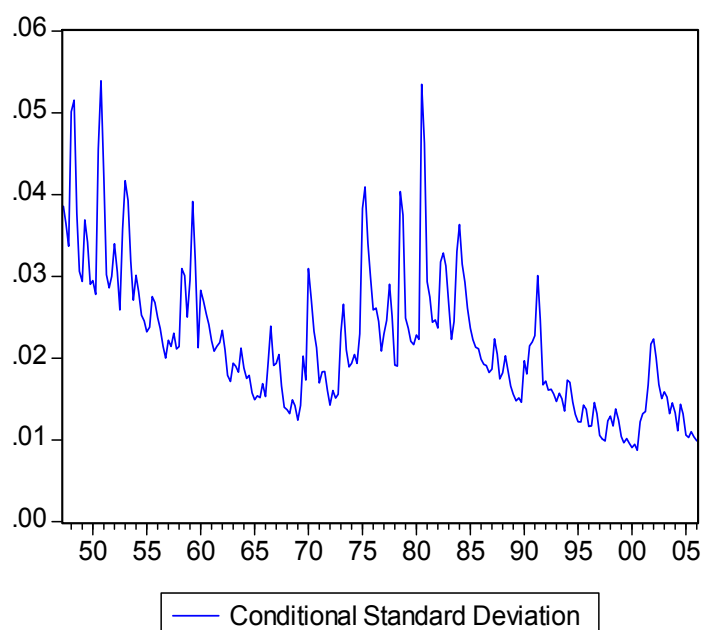


Figure 8a. USA: Volatility in the Growth of Capital Stock

In general, real investment is more volatile in the US than in the Euro area (see Figure 8a). Our time series for the U.S.A. starts before 1950 and shows a period of diminishing volatility until the mid 1960s (during the Golden Age). A dramatic increase in uncertainty occurs during the break-up years of Bretton Woods and then a long period of returning to high economic stability during the Greenspan years. This trend is interrupted by the two Bush presidencies.

For Euroland, our data series is shorter. After the set-up of the European monetary system, a higher degree of stability prevails at first, but is low in the second half of the 1980s. The 1990s are shocked by the ERM-crisis in 92/93 and financial instability in the mid-1990s. With the creation of the Euro a high degree of macroeconomic stability has been restored. This is an interesting result. It shows that European monetary union has attained its objective: stability. But why has the improved macro-environment not translated into higher growth? The answer is found in the low steady state investment growth in Euroland. Autonomous investment growth is more than twice as high in the U.S. (1.9 percent) than in Europe (0.8 percent). An explanation for this difference may be found in the long-term policy mix.

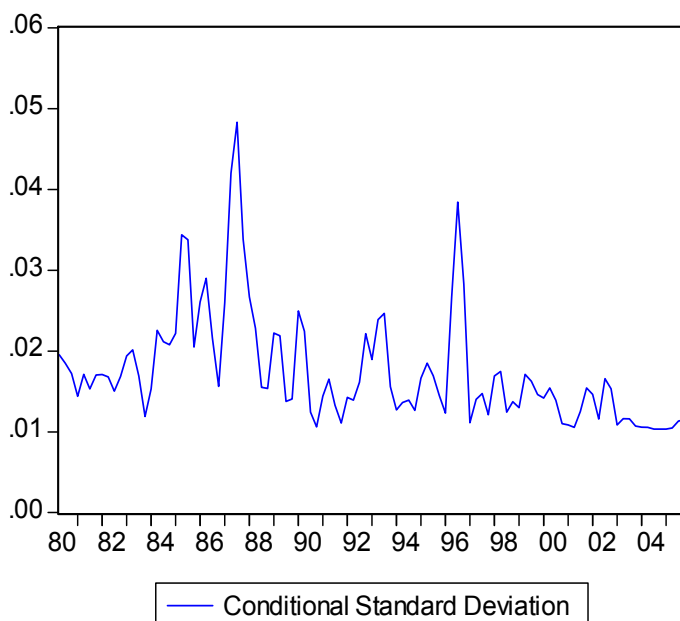


Figure 8b. Euroland: Volatility in the Growth of Capital Stock

### It's the Deficit, stupid!

In a large and fairly closed economy, the key to active demand management is the interaction between budget and monetary policy. This interaction may matter from a short term perspective when excess savings prevent potential output from being absorbed by effective demand or from a growth perspective in the steady state. The short term effect occurs when individuals will not hold real capital unless its yield exceeds some minimum required return. Keynesian policies seek to reduce interest rates to make real investment more attractive relative to financial assets or to increase the government deficit to provide demand for the resources that would not otherwise be used. Such policies are adequate to tackle the problem of excess savings, but they do not solve the problems with low steady state growth, which is Europe's problem. As Feldstein (1980) has shown a long time ago, in an environment of low inflation and reasonable stability of savings, *budget deficits will lower the accumulation of capital in the steady state*. One therefore has to distinguish between the short term effects for the fiscal-monetary policy mix, which are supposed to restore overall macroeconomic stability after shocks, and the long-term growth effects of different steady-state policy mixes.

From a theoretical point of view, the interaction between fiscal and monetary policy should have a negative trade-off if the economy is in equilibrium. This is evident from Figure 9. The downward sloping efficiency lines represents the set of all efficient policy mix points where the economy is in equilibrium, without inflation or rising unemployment. In other words, it reflects a zero output gap. Above the line, say at point A, the combination between fiscal and monetary policy is too tight and the economy is in a deflationary position with rising unemployment. Below the line, the mix is too loose and inflationary pressures occur. For simplicity we will assume that

the efficiency-line is stable.<sup>19</sup> The argument for a negative slope of the efficiency line can be made in terms of long term interest rates in the government bond market (Feldstein 1980), or in terms of monetary policy adjustments in the short-term money market (Collignon 2003a, Annex 3).

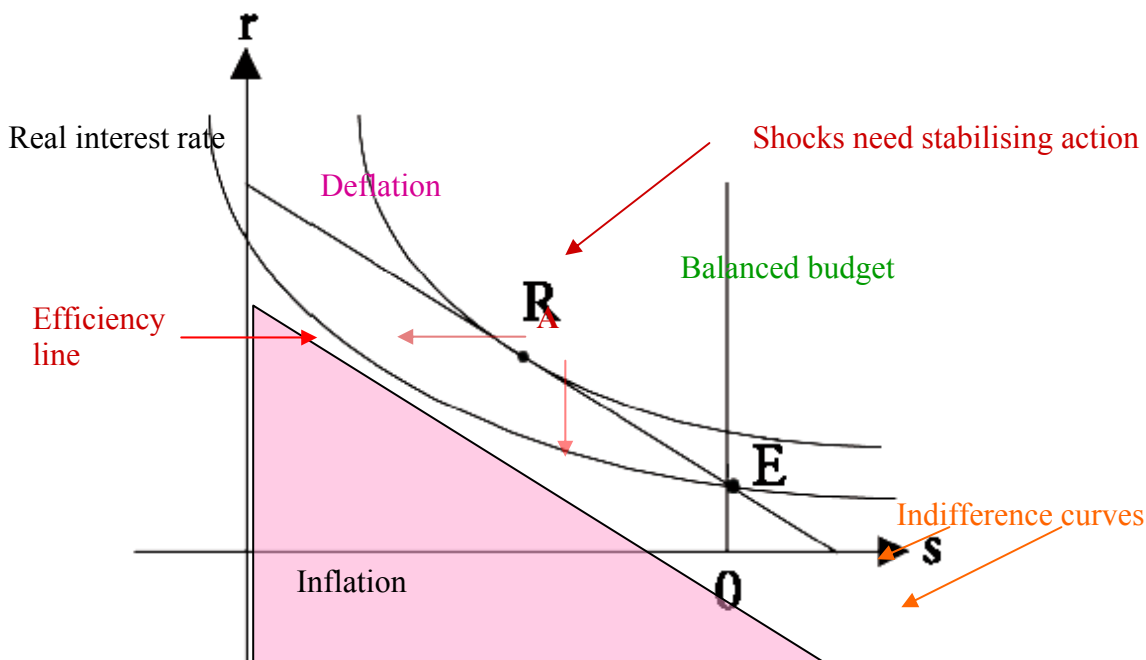


Figure 9. The Optimal Policy Mix

A loosening of fiscal policy, i.e. higher deficits, would then imply tighter monetary policy, i.e. higher interest rates, to keep inflation at bay. Tighter fiscal policies should cause rates to come down. The specific combination along the trade-off curve represents a specific policy mix. For example, the Reagan/Volker policy mix in the 1980s reflected high deficits and high interest rates in the US. This is point R (Republican) in Figure 9. When Bill Clinton ran for President in 1992<sup>20</sup>, he promised to bring the deficit down in order to stimulate growth and employment by lower interest rates (Woodward 2000). Thus, the Democratic policy mix is somewhere near point E. Low interest rates will stimulate investment. Not surprisingly, the Clinton/Greenspan mix of the late 1990s was characterised by budget surpluses and low interest rates, high growth and macroeconomic stability.

Equilibrium positions on the policy mix trade-off curve reflect collective time preferences for intergenerational tax burden sharing. The choices can be represented by an indifference curve that picks an optimal policy mix out of the infinite possibilities assembled on the efficiency line. The public choice of a policy mix is the implicit result of electoral decisions and reflects the consensual preferences among a majority of citizens. These preferences emerge gradually from collective deliberation

<sup>19</sup> In a stochastic setting the shocks are i.i.d, and the efficiency-line would reflect the co-integrating vector. We cannot pursue this line of reasoning in this paper.

<sup>20</sup> His motto was "It's the economy, stupid!"

and political debates. These debates are intensified during electoral campaigns when competing parties bundle policies into specific programs and voters have to make up their mind what to choose. Of course, citizens do not debate in abstract terms: "What is our optimal policy mix?". But when parties and candidates propose a tax cut without saying where they intend to reduce expenditure, they implicitly suggest higher deficits and therefore higher interest rates. Choosing such a candidate implies choosing a policy mix. During the 1992 US elections, the budget deficit was widely discussed, due to the independent candidate Ross Perot. Clinton won as he captured the median voter. In 2000 Republicans promised to "return" the budget surplus to tax payers, while Al Gore sought to use it for improving health care. The implicit choice of a policy mix within a broader bundle of policies is therefore at the core of any democratic society.

In Europe, the conduct of fiscal policy is more complicated and less democratic. From an economic point of view, what matters for the policy mix in the same currency area is the aggregate fiscal stance for the whole of Euroland that interacts with the single monetary stance of the ECB. Yet, in Europe's *governance without a European government*, fiscal policy is determined autonomously by 12 national governments. As discussed above, this creates collective action problems. Adhering to the Stability and Growth Pact would guarantee reasonably low equilibrium interest rates. But as Figure 1 has shown, the SGP rule is not implemented.<sup>21</sup> We have explained the failure to implement the SGP (balanced structural budgets) by "Europe's governance with many governments" that cannot deal efficiently with exclusive public goods. Fiscal policy is such a good. I now will show that Euroland's fiscal policy arrangement creates a bias for high equilibrium interest rates and therefore for lower steady state investment.

The SGP has often been criticised for being insufficiently flexible. However, it is not sufficiently understood that the Pact imposes effectively two forms of inflexibility: (1) it constrains effective stabilisation policy in the short run, except for a limited range of automatic stabilizers.<sup>22</sup> (2) In the long run it impedes democratic choices regarding the intergenerational justice of tax burdens because it imposes a balanced structural deficit. The SGP is therefore incompatible with *alternative* choices on the efficiency line, such as the implicit shift from Reagan/Volker to the Clinton/Greenspan policy mix in America. It imposes point E on the efficiency line once and for all for each member state. The question is which of these two inflexibilities dominates Euroland? Given that macroeconomic instability has disappeared, as we saw in the last section, short-term inflexibility does not seem to be a major issue. The main problem with Euroland's economy must be the equilibrium position of the policy mix.

Figures 10a and 10b show the interacting movements between fiscal and monetary policies for the USA and Euroland. The long-term trend line reflects a negative trade-off. This is what theory would let us expect.<sup>23</sup> The trend-line has a slope of -0.417 in

<sup>21</sup> Figure 10b provides, however some evidence that the excessive deficit procedure under the Maastricht Treaty, which is associated with penalties, has more binding power.

<sup>22</sup> It is sometime argued that there is an adjustment problem for countries, which have started EMU with high debt and deficits, thereby constraining their automatic stabilizers. Nearly 10 years after the EMU-decision was taken, this line of argument seems daring. If France or Italy still has large budget deficits, it is a matter of political choice and not of business cycle.

<sup>23</sup> The assimilation of the trend-line with the efficiency-line is justified if we assume that in the long run output gaps should balance out.

the United States and -0.473 in Euroland. Thus, the two economies operate in a remarkably similar fashion. The structural improvement of the aggregate budget position by one percentage point of GDP will lower the equilibrium interest rate by 41.7 base points in the US and by 47.3 base-points in Europe. If Euroland would stick to the Stability and Growth Pact, the equilibrium interest rate in the capital market would be a full percentage point lower.<sup>24</sup>

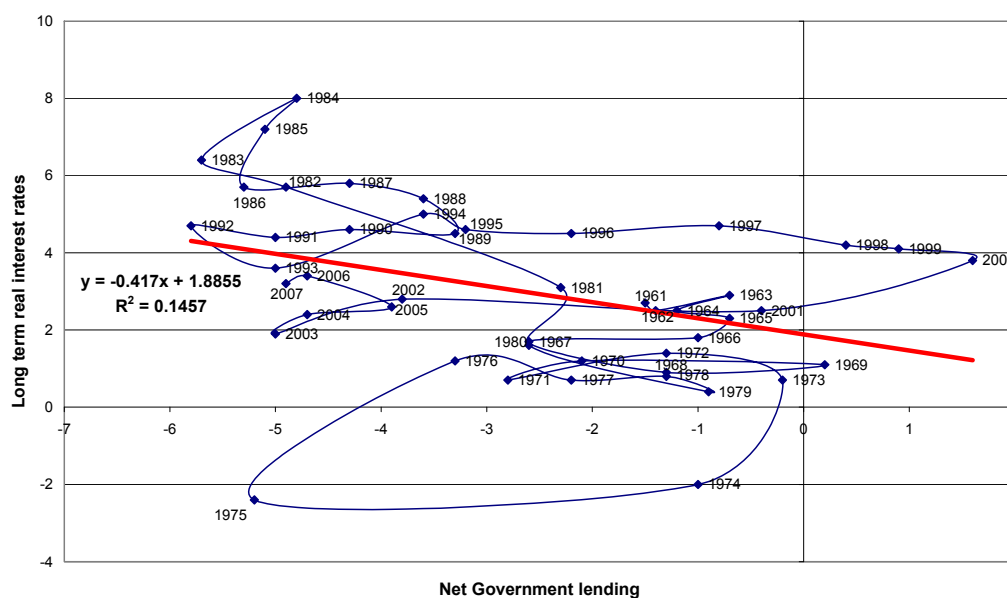


Figure 10a. Policy Mix USA

Shifts along the optimal policy mix curve seem frequent in the USA, see Figure 10a. The inflationary period (below the line) of the late 1960s and 1970s is clearly perceptible; the same applies for the Bush Jr. presidency 2001-07. The late 1980s suffered from overly restrictive policy mixes and high deficits and high equilibrium interest rates. It is interesting that the fiscal consolidation of the Clinton years has reduced the equilibrium interest rate by nearly 200 base points, but took place in the context of a relatively restrictive macroeconomic environment. The overall message is clear: balancing budgets lowers equilibrium interest rates.

In Euroland a clear shift has taken place after the introduction of the euro. Figure 10b shows the cluster of excessively tight European policy mixes in the early 1990s. Deficits were high at that time, with an implicit maximum limit of 6 percent. But monetary policy was excessively restrictive, when Bundesbank dominated Europe, and repeated currency crises in the European monetary system caused high risk premia in financial markets. After the ECB had taken over, Euroland's policy mix has become more accommodating, even if the ECB at first needed to establish its reputation as an inflation fighter. However, fiscal consolidation fatigue after 2000 has pushed the steady state policy mix back to the left again. This move can be explained by the collective action problem in designing a coherent aggregate fiscal policy stance.

<sup>24</sup> Thus balancing budgets would achieve the "euthanasia of rentiers" so famously advocated by Keynes.



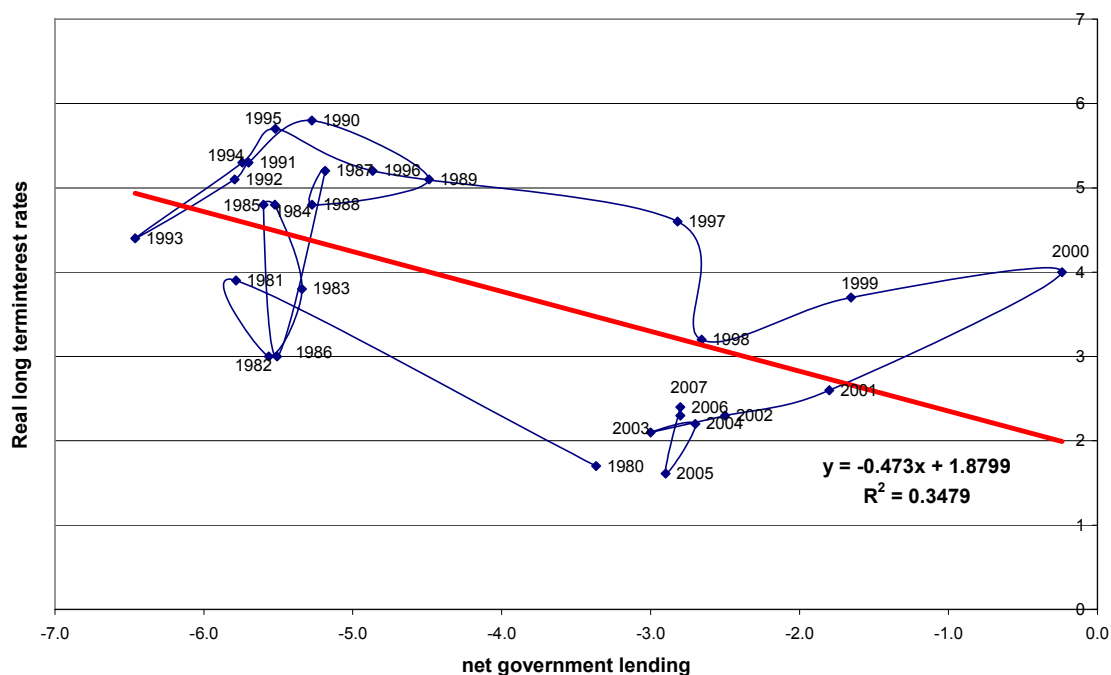


Figure 10b. Euroland Policy Mix

Here is why: Assume we start in equilibrium and one government decides to borrow at the low prevailing rates. This is a demand shock that pushes *the whole system* into an inflationary disequilibrium and requires monetary tightening. However, because the aggregate budget position is determined as the random outcome of each member state's policy, fiscal policy cannot be used as a stabilisation policy instrument for the integrated Euro-area. In other words, no other country will change its own policy stance and consolidate in order to keep the aggregate policy mix in equilibrium. Only monetary policy has the flexibility to respond at the European level. If uncoordinated national policies increase the aggregate deficit, euro-interest rates need to go up. Thus, the apparent monetary tightness of the ECB is the product of Europe's "governance with many governments". The higher equilibrium interest rates may affect economic growth in all member states negatively, so that as a consequence of one member state's deviating behaviour, *all* national budgets are falling into deficits. A picture of fiscal indiscipline emerges, which may push the ECB raise interest rates even further. These countries will now complain that interest rates are "too high", although the ECB has simply restored macroeconomic equilibrium. *The new equilibrium, caused by the free-riding behaviour of one actor, reflects a higher aggregate structural deficit and higher interest rates for all.* Because Euroland's citizens cannot democratically determine the aggregate policy mix along a stable trade-off curve, the central bank has a persistent bias for conservatism.

Increasing the efficiency of the policy mix would require turning the aggregate budget stance into a policy tool for stabilisation policy and at the same time imposing strict discipline on individual member states to stick to the defined policy. Thus, *the correct reform of the SGP would be more flexibility for the aggregate fiscal policy position and less discretion for individual member states.* The "reform" of the SGP in 2005 has achieved exactly the opposite: individual countries have now more leeway to justify higher

deficits, while the aggregate position is the random outcome of uncoordinated free-riding. The consequences are higher equilibrium interest rates, lower growth and more unemployment. Europe will remain the least dynamic region in the industrialised world economy.

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

Moreover, there are some simple ideas in the public debate about how to design coherent, yet flexible, institutional arrangements for fiscal policy in Euroland (see Amato 2002; Casella 2001; Collignon 2004b). For example, one may define the optimal aggregate fiscal stance at the Euro-level by transforming the Broad Economic Policy Guidelines into a “DPEF europeo”.<sup>25</sup> This would give flexibility in reacting to macroeconomic shocks. The aggregate stance would then need to be broken down into national (and even regional) deficit quota for which each jurisdiction would obtain deficit permits. If one jurisdiction does not use its quota, it would be allowed to sell the permits to another authority that wishes to borrow more. This system, inspired by tradable pollution permits, would achieve vertical flexibility reflecting fundamental preferences for borrowing and taxes, and horizontal flexibility between different jurisdictions and overall coherence in the fiscal position.

### **The question of democracy**

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

I have discussed the issue of fiscal policy and democratic legitimacy in separate papers (Collignon 2007; Collignon 2004b). The problem is the following. According to the classical definition, a democratic constitutional state is a political order “created by the people themselves and legitimated by their opinion and will-formation, which allows the addressees of law to regard themselves at the same time as the authors of the law” (Habermas 2001). Thus, voting for a government is the political act that allows citizens to regard themselves as the ultimate authors of laws, i.e. as the sovereign. But prior to the vote, political debate is the necessary condition for collective will-formation.

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<sup>25</sup> See Amato (2002). Documento di Programmazione Economico-Finanziaria (DPEF – Document of Economic and Financial Programming) is the Italian macroeconomic framework law, which gets voted before the finance minister can put forward his annual budget. France's Vth Republic introduced a similar tool to overcome the budgetary inconsistencies of the IV Republic.

However, in the European Union, policy decisions are not democratic in this sense. Certainly, citizens are able to revoke national governments at national elections after a national debate has produced the collective will within this constituency. But, with respect to European public goods, national governments can never represent all European citizens; they act as the agent of a “principal” that is only a faction of the European population. These national agents then decide policies at the European level that affect all European citizens, although they represent only the will of some European citizens. This is different from democracy in a national setting, where members of parliament are responsible to their constituency *and* for achieving the collective good.<sup>26</sup> The democratic will formation in one country has externalities for all other national constituencies. With respect to stabilization policy, this externality is a consequence of unifying the monetary system and having a single interest rate determined by the European Central Bank. In general, policy compromises negotiated at the European level are superimposed on a majority of citizens who were not involved in the process of collective will formation and therefore do not consider themselves as “authors of law”. As this process is repeated for every individual country, European policy decisions will never command the same degree of democratic legitimacy as national decisions.

Moravcsik (2002) has denied the existence of a “democratic deficit” in Europe, arguing that the EU simply operates like any “advanced industrial democracy”, because technical functions of low electoral salience are often delegated to specialized institutions. Thus, output legitimacy (good results) trumps input legitimacy (the right to choose). This view may have been justified when the scope of European integration was relatively narrow. It may be valid for inclusive public goods, which can be regulated by “governance without government”. But when European policies such as monetary policy or the Lisbon agenda touch every European citizen’s way of life, and when fiscal coordination reaches the sacrosanct domain of “no taxation without representation”, it is a matter of the normative coherence of modern society that European citizens must have a right to choose collectively. Yet, the only institutional channel through which they can express their choices is national and not European democracy. Hence, national interests dominate the European interest and collective action problems prevent efficient policies. The only logical solution of the dilemma is setting up a European government that is elected by all European citizens and responsible for the administration of the European exclusive goods, which affect them all. The coherence of input and output legitimacy is then restored, the cooperation failure is overcome and economic and political efficiencies are reduced.<sup>27</sup>

## Conclusion

The prospects for Europe’s future are bleak, but not hopeless. If Europe continues with the undemocratic intergovernmental approach of Lisbon, it takes little

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<sup>26</sup> In representative democracies members of parliament are elected after a national debate, which is structured by the campaigns of political parties. The MP therefore has an interest to secure a majority for his party. In the EU, there is no constituency transcending institution like parties. The campaigns are also constitutive elements of will formation. The *Council operates more like an eternal parliament that replaces its members exclusively through by-elections*, but no campaign takes place because none is accountable to the whole European constituency.

<sup>27</sup> See Collignon (2003a) for a more extended analysis of the centralization/decentralisation trade-off and the dilemma of what call there type I and II inefficiencies.

imagination to see that after 50 years of European unification, the European Union will die a slow death by gridlock, economic stagnation and un-kept promises. Nor can we exclude a more violent crisis with extreme right wing parties coming into power. The results of the constitutional referendum in France and the Netherlands gave an early taste of re-emerging nationalism. Alternatively, Europe takes a leap forward and creates a proper democracy, where all European citizens choose their common government for the administration of European public goods. European policy choices are then the outcome of democratic debates. I have called such a democratic system for the EU *the European Republic* (Collignon 2003a; 2004a); the Belgian Prime Minister Guy Verhofstadt (2006) has referred to the old idea of the *United States of Europe*. However, the fundamental dilemma remains: which national government will wish to set up a European democracy if it loses its own power? Perhaps the only way forward is that citizens mobilize themselves and work through political parties in Europe. After the collective trans-European deliberation, which follows from party competition, a new democratic consensus might emerge and impose citizens' preferences for democracy on resistant national governments.

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## Annex

### Euroland Quarterly

Dependent Variable: EURO\_QUARTER

Method: ML - ARCH (Marquardt) - Normal distribution

Date: 06/04/06 Time: 13:26

Sample: 1980Q2 2005Q4

Included observations: 103

Convergence achieved after 23 iterations

Variance backcast: ON

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

	Coefficient	Std. Error	z-Statistic	Prob.
@SQRT(GARCH)	-0.272058	0.371735	-0.731859	0.4643
C	0.007970	0.005570	1.430964	0.1524
Variance Equation				
C	0.000106	3.92E-05	2.690469	0.0071
RESID(-1)^2	0.438561	0.229310	1.912523	0.0558
RESID(-2)^2	0.326469	0.239623	1.362426	0.1731
R-squared	-0.040404	Mean dependent var		0.004731
Adjusted R-squared	-0.082870	S.D. dependent var		0.017706
S.E. of regression	0.018425	Akaike info criterion		-5.283531
Sum squared resid	0.033269	Schwarz criterion		-5.155631
Log likelihood	277.1018	Durbin-Watson stat		2.295435

**US Quarterly**

Dependent Variable: GR\_FI\_US

Method: ML - ARCH

Date: 06/02/06 Time: 18:08

Sample (adjusted): 1947Q2 2006Q1

Included observations: 236 after adjustments

Convergence achieved after 39 iterations

Variance backcast: ON

$$\text{GARCH} = C(3) + C(4)*\text{RESID}(-1)^2 + C(5)*\text{RESID}(-2)^2 + C(6)*\text{RESID}(-3)^2 + C(7)*\text{GARCH}(-1)$$

	Coefficient	Std. Error	z-Statistic	Prob.
@SQRT(GARCH)	-0.342548	0.209732	-1.633266	0.1024
C	0.019016	0.003665	5.188743	0.0000
Variance Equation				
C	-1.31E-07	4.04E-06	-0.032425	0.9741
RESID(-1)^2	0.281047	0.102087	2.753017	0.0059
RESID(-2)^2	-0.056367	0.119778	-0.470595	0.6379
RESID(-3)^2	-0.159850	0.069779	-2.290807	0.0220
GARCH(-1)	0.935525	0.033684	27.77359	0.0000
R-squared	-0.024989	Mean dependent var		0.010338
Adjusted R-squared	-0.051845	S.D. dependent var		0.022270
S.E. of regression	0.022840	Akaike info criterion		-4.868640
Sum squared resid	0.119458	Schwarz criterion		-4.765899
Log likelihood	581.4995	Durbin-Watson stat		1.264102



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