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Democratic Surveillance or Bureaucratic Suppression of National Sovereignty in the European Union?

Ideas on the Multilateral Surveillance Regulation

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BRIEFING PAPER

Abstract

This paper argues that the problems of coordination failure and the insufficient enforcement of common policy rules that have caused the Greek crisis are due to a lack of democracy at the European level. Unless reforms take this democratic dimension in consideration, future crises are inevitable. The proper way of solving this problem is involving the European Parliament as a democratic legislator in multilateral surveillance.

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La pensée unique est morte! Vive la pensée unique ! The recent euro-crisis has highlighted the limits and flaws in the current system of governing the economy of the European Union. It has proven that intergovernmental policy coordination is not able to produce optimal policies for Europe's citizens or even to prevent a near-fatal breakdown of the euro. Not surprisingly, the failure to generate welfare improving policy output contributes to the growing Euroskepticism and the gradual loss of legitimacy for the European integration project. Long gone are the times, when a permissive consensus allowed governments to go ahead and build Europe in the manner of "enlightened despotism" (Laumen and Maurer, 2006; Hooghe and Marks, 2008). Shocked by the crisis, European Union and member state authorities have now come up with a variety of propositions for reforming Europe's economic governance, which aim at raising the efficiency of European Union's governance, i.e. at improving the system's output, but they all avoid dealing with the core problem: who is legitimizing European policy decisions? How is it possible that governments tell each other what to do, when each has been democratically elected to something else?

While it is now a common place to state that "neither the Member States nor the Commission have correctly implemented the Maastricht Treaty" (European Parliament, 2010), the reasons behind this coordination failure remain in the dark. For example, the Commission has nothing else to say than that the recent crisis "*showed gaps and weaknesses in the current system, underlining the need for stronger and earlier policy co-ordination, additional prevention and correction mechanisms and a crisis resolution facility for euro-area Member States*." The ECB goes a step further and finds: "*The disappointing performance of fiscal policies under the EU framework was due to the weak governance of the Stability and Growth Pact (SGP), notably (i) a lack of enforcement of fiscal discipline at the EU level and (ii) insufficient national incentives to comply with the EU rules*." Yet, this begs the question why the governance was so weak and what kind of incentives are needed to improve the situation. Most reformers fail to see that democratic member states are responsive to national constituencies, and that this often leads them to ignore the European collective good as long as there is no European authority that can legitimately overrule and stop their uncooperative behavior. Yet, the Treaty on European Union obliges member states to "*facilitate the achievement of the Union's tasks and refrain from any measure which could jeopardise the attainment of the Union's objectives*" (art. 4.3) and to treat all citizens equally.[1] I will argue that the only way to achieve this is through a democratic European Economic Government. The French government used to call for a *gouvernement économique* for the Euro Area, but it never specified what it meant, presumably because it was afraid of the unintended consequences. Unfortunately, the recent Franco-German Paper[2] is a blueprint for how *not* to create an economic government. Before they are designing reforms of Europe's governance, European policy makers must learn the lessons from the past. If the logic of previous failures is not understood, nothing is learned from mistakes, and the solutions will hardly improve policy outcomes in the future.

The emerging consensus among policy-makers[3] now focuses on three areas: (1) strengthening surveillance over budgetary policy in the Stability and Growth Pact; (2) setting up a framework for competitiveness surveillance and the correction of economic imbalances and (3) the design of a euro area framework for crisis management. All these proposals seek more efficient coordination of policies amongst mainly national actors, although most see the need for a stronger role of the European Commission and the European Central Bank (ECB).

[1] Art. 9 of the Lisbon Treaty (TEU) states: "In all its activities, the Union shall observe the principle of the equality of its citizens, who shall receive equal attention from its institutions, bodies, offices and agencies."

[2] République française, 2010

[3] See European Commission, 2010; ECB, 2010; European Parliament 2010; République française, 2010. The Van Rompuy task force by the European Council is to report in the autumn of 2010.

Few have the uncompromising boldness of the ECB, which proclaims that the economic governance in the Euro Area "*require(s) a quantum leap in terms of progress towards strengthening the institutional foundations of EMU, and thus towards a deeper economic union that is commensurate with the degree of economic integration and interdependency already achieved through monetary union."* Having argued myself for years that the Euro Area governance needs a further step to a proper government,[4] I could not agree more. However, there is an important dimension missing from the new institutional consensus: the role of democracy. Most reform proposals seem closer to running the Soviet Union than a modern social market economy. They tacitly assume that member states are entitled to act for the Union as a collective of sovereigns, while this is precisely the problem: partial interests dominate the general interest. Intergovernmentalism is like the tail wagging the dog. This model of policy making keeps reproducing coordination failure in the European Union again and again. Hence, improving Europe's economic governance requires posing uncomfortable questions about policy making in the European Union.

In my last paper for the Monetary Dialogue (Collignon, 2010), I made some concrete proposals on policy improvements after the crisis. In this paper I will concentrate on the need of a democratic framework for economic policy reforms and then comment on some of the fault lines in the existing policy proposals by European authorities.

1. A democratic framework for reforming Europe's economic governance

With the creation of the euro in 1999, the quality of and the requirements for policy coordination have profoundly changed, but the methods by which Europe is governed have not. In the early stages of European integration, the emphasis was on synergies, positive sum games, and benefits, which generated an incentive for nation states to cooperate voluntarily. With the creation of the single market and the common currency such incentives can no longer be taken for granted, although they have not totally disappeared. The logic of voluntary coordination still works well in the "old" policy areas like foreign trade, common agricultural policy, and competition policy. However, a whole new range of "exclusive" European public goods has emerged, where member states are easily tempted to free-ride on their colleagues.[5] I will show below that this transformation is systemically linked to monetary union.

Europe's new economic environment requires new forms of governance that go beyond intergovernmental cooperation and the Commission's traditional role of supporting member states' policy coordination. For this reason, I will not distinguish in this paper between "pure" intergovernmentalism and the so-called "Community method".[6] The traditional role of the Commission in the Community method was to *facilitate* policy coordination between member states and for this purpose it had certain privileges, notably the monopoly of proposition. Member states, however, remained "sovereign" actors who would concede only case by case if and what competences they would transfer to the Union (Bundesverfassungsgericht, 2009). Thus, even if the Commission had an eminent role as coordinator, the ultimate decision making power remained with nation states. The only genuine exception is monetary policy, where the European Central Bank has assumed the "independent" power of decision making and implementing.

[4] See references: Collignon a-g.

[5] In my June policy paper to the Economic and Monetary Affairs Committee (Collignon, 2010), I have discussed the collective action problems related to these new European public goods. See also Collignon (2003 b) for a full discussion.

[6] For an explanation of these two methods see: http://europa.eu/scadplus/glossary/community_intergovernmental_methods_en.htm

The Lisbon Treaties have opened the way for new practices of policy making. The "ordinary legislative process" (art. 294) sets a procedure for the interaction of Commission, Council and European Parliament. It specifies how *legal acts* are adopted and whom they bind (art. 289 and 294). They have the potential to improve substantially the democratic legitimacy of policy making at the European level, because legal acts need the approval of the European Parliament, which represents European citizens as a whole.[7] Thus, the European Union has now established an institutional framework, through which policy decisions at the European level can gain a degree of legitimacy, which was hardly accessible before. However, to realize this progress, it is necessary that the proposed reforms of multilateral surveillance of economic policies strengthen the role of European secondary legislation when regulating what is of "common concern".

The intergovernmental fallacy

As the European economy has become more integrated, the decisions by one member state often cause significant external effects that spill over to all other member states. As a consequence, millions of European citizens are affected by decisions of governments they were unable to elect and are incapable to influence. For example the government of Konstantin Karamanlis was elected by 1.2-1.5 million voters in 2000, 2004 and 2007, but in 2010 the consequences of his policies have hurt over 329 million citizens in the Euro Area. Similarly, the German Chancellor Angela Merkel was more concerned with getting 2.6 million votes in the regional elections in Nordrhein-Westfalen by catering to German chauvinism, than with stabilizing the euro in the midst of its deepest crisis. These examples show that what seems democratically legitimate in the context of nation states, may have devastating effects for the European Union. Thus, policies for the European Union cannot be made by member states alone. No national government can claim that it has a legitimate right to design policies, which affect all Europeans, but I will show that the (European) Council is also lacking the legitimacy to act as a European government.

One may object that all European governments are democratically elected, and therefore the European Council has the democratic legitimacy to act on behalf of European citizens. In the words of Andy Moravcsik (1993), the EU is "an international regime for policy coordination, the substantive and institutional development of which may be explained through the *sequential analysis* of national preference formation and intergovernmental strategic action" (my italics). This so-called two-level (Putnam, 1988) or multi-level (Hooghe and Marks, 2001) governance assumes that preferences are first formed with respect to national considerations and then traded off by governments when they make deals with their colleagues. Studies of international coordination have emphasized the importance of a common conceptual framework as a precondition of for collective action. Unless there is a shared diagnosis of the problem, policy makers from different countries are unlikely to sustain cooperative policy responses (Eichengreen, 2007). The European Union has set up a fairly solid institutional framework for generating consensus among policy makers. However, it does not address the fact that even if they agree on a conceptual framework, policy makers may be constrained in their capacity to act cooperatively if they respond to national constituencies, which do not share the consensual preferences among elites. The problem with the sequential approach is that it disables citizens from forming preferences for specifically European policies that affect all Europeans and the resulting democratic deficit makes it difficult to impose the common European interest on non-cooperating member state governments. This is the core problem of policy coordination in Europe, but talking about it remains Europe's biggest taboo.[8]

[7] TEU, art.10.2.: "Citizens are directly represented at Union level in the European Parliament."

[8] It also violates the spirit of the Lisbon Treaty, which states in art. 1: "This Treaty marks a new stage in the process of creating an ever closer union among the peoples of Europe, in which decisions are taken as openly as possible and as closely as possible to the citizen."

Early European federalists did address the issue, but they have lost the battle (Nicolaidis and Howse, 2001). One reason is that they never transcended political thinking in terms of identities.[9] Idealistic federalists like Albertini (1993) thought of European identity as the universal human culture that would incorporate into a state-like federation in order to maintain "peace". Yet, nation states have preserved national identities. Neofunctional federalists were more realistic in limiting their efforts to the partial centralization of competences, although they too believed that federations are made up by states (Haas, 2004). Yet, one consequence of the state-centred identitarian approach to European integration is that policy conflicts are articulated as conflicts between member states rather than as interests between groups of citizens. It therefore ignores democracy as a mechanism for solving conflicts.[10] Given that a European identity has not been forthcoming in the way European federalists had hoped, it was then only a small step to turn from the idea of centralization in a federal "superstate" to the principle of subsidiarity.

Subsidiarity means decentralizing decision making. The Lisbon Treaty (TEU) defines in art. 5: *"Under the principle of subsidiarity, in areas which do not fall within its exclusive competence, the Union shall act only if and in so far as the objectives of the proposed action cannot be sufficiently achieved by the Member States, either at central level or at regional and local level, but can rather, by reason of the scale or effects of the proposed action, be better achieved at Union level."* The problem with subsidiarity is that one often only knows after the crisis that more centralization was needed. Take as an example the surveillance of public finances. When the Commission requested to check statistics supplied by member states, it was blocked by the Council under French and German leadership with the argument that the collection and supply of statistical data was a member state prerogative. Now that the damage is done, everyone seems to agree that more centralized control could have avoided at least the depth of the Greek crisis.

However, concern with the allocation of power is justified. The proper criterion must be the reach of public goods. If a law or regulation affects all European citizens, it must be made at the European level, otherwise at the national or local level. Applying the principle of subsidiarity to democracy means that policies decided by national governments are democratically only legitimate as long as they deal with the exclusive interests of national constituencies, while policies decided at the European level need to be approved by those who are affected and concerned by them, i.e. by all citizens.

The republican case for European democracy

As an alternative to the sequential analysis of intergovernmentalism and the centralizing approach of federalism, I propose a *parallel approach* to Europe's governance, which stands in Europe's republican tradition. [11] It derives from the functions of European public goods and requires disentangling what is national and what is European. Today, national governments are elected on the basis of policy proposals that amalgamate national and European policy dimensions. Voters must take the package as it is and cannot distinguish between their national and European interests. Because the national dimension is dominant, the decisions are also dominated by national concerns. This "bundling effect" generates the impression of "national preferences", which governments defend when they negotiate "in Brussels". They draw "lines in the sand", negotiate compromises and return as heroes who have saved the "national interest" against all adversity. Yet, given that the compromises may only serve partial interests, the general interest of all citizens is often neglected or even damaged. The harmful effects apply usually also to the interests of those who live in the member state whose government was able to impose its will.

[9] In fact, this is a defining characteristic of federalism since Althusius first came up with the idea in the 17th century.

[10] Most famously, the German Constitutional Court proclaimed that there can be no European democracy as long as there is no European *Volk*. See: Bundesverfassungsgericht 1995 and Weiler, 1995.

[11] See Collignon, 2003, 2004, 2007, 2008, 2008a

Take Greek fiscal policies. Running large deficits may have served some social groups in Greece, but the consequences are disastrous for all Europeans, including Greeks.

Hence, it is the policy making structure of intergovernmentalism that harms Europe's welfare and prevents the formation of collective European policy preferences because the European general will can only emerge through debates among *free and equal* citizens,[12] i.e. through the common deliberation about the consequences of policies that affect them all. A rival view claims that European policy preferences do not exist, because there is not a "European people" (Bundesverfassungsgericht, 1995; Weiler, 1995), by which is meant that citizens do not "feel" a homogenous cultural identity.[13] However, the state-centred communitarian approach is precisely what European integration seeks to overcome. As Jean Monnet once said: « Nous ne coalisons pas les états, nous unissons les hommes ». Without doubt, individuals have various identities and whilst these forms of belonging are important for their individual life designs, political choices, and especially economic choices, are ultimately made about interests. Individuals become united in their interests when they can agree through public deliberation and communication on what is good for them. Such public deliberation needs institutional structures, which the intergovernmental system does not provide and even inhibits.

The lack of democratic practices at the EU level limits intergovernmental legitimacy to national debates, and governments negotiate under the constraint of what national debates allow them to do. As a result, intergovernmentalism generates a weak overlapping consensus between partially legitimated governments, although it rarely creates consensus between citizens. The advantage of the intergovernmental consensus is that it overcomes conflict between states, and this form of keeping peace was certainly an attractive purpose of European integration after two World Wars; but its weakness is a handicap when it comes to implementing policies. In order to strengthen the effectiveness of policy coordination, the weakness of intergovernmental consensus must be compensated by democratic legitimacy emanating from citizens.

One may object that in their national contexts voters also have to accept programs as they are presented by political parties and that they cannot design policies themselves. Yet, the essential difference between nation state democracies and the lack of it in Europe is that, in national politics, political parties compete for the office of government and this makes them responsive to the debates and preferences of their potential voters; in the European Union this does not happen, because a European government does not exist. By definition, member state governments are not accountable to a European constituency, and they need to satisfy only a faction of European citizens. Only the existence of a democratically elected government at the European level would generate the competition between political parties, which seek to form such government and will therefore offer citizens the choice between alternatives.[14]

There are many theories of democratic legitimacy. In essence they all claim that citizens must have a choice over policies that affect them. Since the French Revolution we consider that citizens, not governments, are sovereign and this means that citizens have the right to appoint and dismiss governments as their agents to implement the policies that they choose.

[12] In an intergovernmental system, citizens are not equal because they "belong" to their governments, so that big states are more influential and powerful than small states. As a consequence, citizens are also not free, because the big impose their will on the small.

[13] One of the least convincing arguments against European democracy is the language issue. Who in France knows anything about Belgian domestic policies, or in the UK about Ireland or in Germany about Austria? The issue is not language and media, but the fact that there is no benefit from gathering information if one cannot institutionally participate in making choices.

[14] Lisbon Treaties, TEU art. 10.4: "Political parties at European level contribute to forming European political awareness and to expressing the will of citizens of the Union."

As Karl Popper (1996:124) pointed out, there are two types of governments: the democratic type consists of governments one can get rid of through general elections; the second type, which he called “tyranny”, consists of governments which the ruled cannot get rid of. Intergovernmentalism introduces a strong portion of tyranny into European politics, because citizens cannot remove the intergovernmental economic government of the Council. Electing a government is the most noble of all democratic acts and it is based on general elections and universal suffrage. However, the intergovernmental system deprives citizens of their democratic nobility, because there are no general elections through which citizens can replace the Council and change the general policy orientations. They can, of course, revoke their national government – which is the $1/27^{th}$ part of the ruling power – but this is hardly the same as “one man, one vote”.[15] They also can elect the European Parliament, but this parliament does not (yet) have the right to appoint a European government, indeed, not even a limited economic government, because the Council has usurpated governmental competences. As Chancellor Merkel succinctly put it: “The economic government is us”. The democratic legitimacy of the European Council as a form of economic government is dubious, to say the least: it violates the democratic principle “one man, one vote” and resembles a very Long Parliament,[16] which never gets dissolved, and which is never elected by General elections, but only by By-elections. In addition, the idea of restricting Europe’s economic government to the Eurogroup is nothing more than the attempt to create a Euro Rump Parliament. Who would call this a democracy?

In order to be fully accountable, a democratic government must make rules, regulations and laws for the citizens by which it is elected. Not more, not less.[17] National governments cannot legitimately make laws for people that have not elected them, but it is also true that a European government must not assume the right to make policies, which do not affect all European citizens collectively. The right to appoint a government only makes sense, if the policy making competences of the government coincide, or are congruous, with the constituency that appoints it. Habermas (2001: 65) has put this requirement into the classical formulation: “*The democratic constitutional state, by its own definition, is a political order created by the people themselves and legitimated by their opinion and will-formation, which allows the addressees of law to regard themselves at the same time as the authors of the law*”. The problem with intergovernmentalism is that it violates the principle of congruence; the problem with European federalism is that it may centralize too much.

The solution to this dilemma of intergovernmentalism and federalism consists in giving Europe’s citizens the right to elect a European government through their representatives in the European Parliament and to limit the competences of this government to only those public goods and policies, which affect all Europeans collectively. For the largest part, these competences concern economic issues in the Euro Area, so that, at least initially, the European government is just an economic government. The proper democratic surveillance of such government would be guaranteed by the fact that the European Parliament authorizes specific policies of macroeconomic management in the European Union and in the Euro Area.[18]

[15] The impact in terms of qualified voting in the Council is determined by the weights in the Lisbon Treaty art.16 and Protocol No 36.

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

[17] The Lisbon Treaties acknowledge this under the topic of subsidiarity and proportionality. See art. 5 TEU.

[18] The high degree of macroeconomic interdependence in the Euro Area (see below) justifies enhanced cooperation (art. 20 TEU), particularly in the Euro Area (art. 136 TFEU). MEPs from member states with derogation from EMU in accordance to art. 139 TFEU or from opt out member states (Denmark and UK) would then not vote on Euro-governance matters, but would participate in the deliberation.

The involvement of the European Parliament would give citizens the opportunity to debate and choose the broad European policy orientations when they are called to elect the Parliament.

The role of national Parliaments

This solution requires the separation of national from European policies. National policies are naturally legitimised by national parliaments and implemented by national governments; European policies need to be authorized by the European Parliament and implemented by a European government. There is a lot of confusion in policy debates about the role of national parliaments in the surveillance of European policies. While it is true that many European laws and regulations need to be translated into national law and, therefore, need to be approved by national parliaments *ex post*, strengthening the *ex ante* role of national parliaments would be counterproductive. It would make the conduct of efficient policy coordination nearly impossible, because it rigidifies negotiations about common policies and re-enforces all the negative effects of intergovernmentalism. It does not improve democratic legitimacy, because, as discussed above, the part cannot rule for the whole. Instead, it damages output legitimacy by strengthening veto players and undermines input legitimacy[19] by facilitating the domination of a minority over the majority. Hence greater involvement of national parliaments in European policy making must be avoided. National parliaments are responsible for national policies; the European Parliament must become responsible for European policies; and the Council must function as the clearing house for conflicts between the two.

If the spillover from national policies affects all European citizens, the efficiency of economic policy requires centralized surveillance. However, because they are all collectively concerned, European citizens must have the right to appoint an economic government that pursues the policies that they choose by majority. Such a European government must logically evolve from the European Commission, which is the guardian of the common interest.[20] Hence, the European Commission must have the full authority to propose rules and regulations and to impose sanctions on member states that do not cooperate, once they have been approved by the European Parliament. However, in order to protect their partial interests, nation states will resist the conferral of power to the European Union. This poses the question: who is the sovereign? Governments or citizens? The modern democratic view is that citizens have the ultimate authority to appoint their agents. The political legitimacy of a European economic government can therefore only come from universal suffrage, and this principle places the European Parliament at the core of Europe's economic governance. Only the European Parliament represents all European citizens, while by definition, member states and national parliaments cannot represent the general interest. The recent refusal of the Slovak parliament to participate in the financing of the European Financial Stability Facility proves how quickly the limits of European solidarity are reached, if there is no democratically legitimated authority that can overrule member states' partial interest.

Unless this fundamental issue of the legitimacy of Europe's governance is resolved, it is impossible to improve the efficiency of policy coordination in any meaningful way, especially when dealing with crisis situations. "European semesters", "independent expert panels", "stronger surveillance of national policies", as discussed in the reform proposals by European authorities, are honourable attempts to make coordination procedurally more effective, but the problem of Europe's coordination failure is not procedural.

[19] The concepts of output and input legitimacy go back to Scharpf, 1999. The first describes legitimacy generated by good results ("*L'Europe des preuves*"), the second is based on peoples preference formation.
[20] Lisbon TEU, art. 17: "The Commission shall promote the general interest of the Union and take appropriate initiatives to that end."

It results from the fact that in specific and limited cases, national policy objectives conflict with the common European interest of citizens. Involving national parliaments in European policy making does not eliminate the conflicts, but is likely to make them more acute. [21]

The legitimacy problem has gained considerable salience with respect to macroeconomic policies in the Euro Area. However, its solution does not require fundamental changes in the Lisbon Treaties. The Treaty on the Functioning of the European Union has created the "ordinary legislative process" (art. 294) that allows the European Parliament to play its role as the representative of European citizens in economic policy. Art. 290 also opens the possibility that *"a legislative act may delegate to the Commission the power to adopt non-legislative acts of general application to supplement or amend certain non-essential elements of the legislative act."* These articles are sufficient to generate the secondary legislation that would allow the democratic control of Europe's economic governance. Many of the reform proposals made by European authorities could become truly powerful, if they would focus less on purely bureaucratic procedures and more on the democratic involvement of the European Parliament as a co-legislator.

2. The transformation of economic governance in the euro area

As the ECB has emphasized, European Monetary Union requires a quantum leap in economic governance and I will now discuss, why that is so.

What a difference money makes

In any properly functioning market economy, money is the *hard budget constraint*. Because it is scarce, it is a constraint for all economic agents who need it in advance of making purchases, regardless of whether they are private or public, firms or consumers, investors or wage earners. In the socialist economies of Eastern Europe, money was a *soft* budget constraint because it was not scarce, and the transition from planed to modern social market economies consisted precisely in making money rather than resources the binding constraint (Kornai, Maskin, Roland, 2003; Riese, 1990).

Modern money is created by the central bank, which needs to keep it scarce in order to ensure that markets function efficiently. This is the principle behind central bank independence and the ECB's primary objective of maintaining price stability. If the ECB were not independent and governments could oblige it to give them money, the euro would become a soft budget constraint. Price stability would be lost and resources would not longer be allocated to their most productive use. Technically, the central bank generates the scarcity of money by imposing liquidity requirements on the banking system, so that it can set the price for money, i.e. the short term interest rate.

The interest rate for money determines the conditions under which the banking system can obtain liquidity and lend it to the "real" economy. These conditions are equal for all economic agents, even if banks and capital markets charge a premium for risk considerations. This logic also applies to governments. In monetary union "sovereign" borrowers are at par with any other debtors, because governments face the hard budget constraint in the same way as any other borrower. It is, therefore, money that defines the Euro Area as an integrated economy. From an economic point of view, a "country" is the currency area and not the jurisdiction that has more or less arbitrarily emerged from history; from a political point of view, things will, of course, appear differently and this difference in perception is the cause of many inconsistencies and conflicts.

[21] Note that citizens of individual member states may themselves be negatively affected by the non-cooperative policies of national governments. It is therefore misleading to talk as if there were conflicts between member states and the Union.

One consequence of the hard budget constraint is that it generates interdependencies with zero-sum distributional dynamics. Economists typically describe this by Walras' Law, which states that excess demand in one market implies over-supply in another. Although this law is traditionally formulated in static terms, it also applies to a growing economy, when money grows in proportion to the real economy, but the above-average growth in one sector or region implies below-average growth in others. Thus in an integrated monetary economy, the effects and performances of one sector are never separate of what happens in the rest of the economy. For example, during the last decade one has observed rapid growth in Southern economies like Greece, Spain, Ireland and stagnation in Germany, while in the recent crises this has turned into the opposite: German growth now exceeds the rest of the Euro Area, while the South is in stagnation.

This interdependence also has political implications as each government has incentives to free-ride on its partners. Because money is a scarce resource, a government seeking to borrow more money than what the banking sector can supply in equilibrium must obtain funds which other governments or the private sector will not use. Otherwise there is an inconsistency of monetary claims that will lead to inflation when demand exceeds the productive potential, or to unemployment when demand for money and credit lags behind. Similarly, if the policies in one member state impede or accelerate growth at home, they will also influence growth in other member states, although the interactions are complex. The boom in one country or sector may stimulate demand in other sections of the economy (Spanish property prices stimulating consumers who will buy German cars) as long as the ECB accommodates it. If it does not, a local boom is only possible if local investment opportunities attract funds which are not invested elsewhere. In this case, the local boom is conditional on slow growth elsewhere.

The phenomenon of shifting booms and busts across regions is well documented for the United States. In Europe, the zero-sum logic is most obvious with respect to trade balances: the net surplus by one member state needs to be absorbed by another. For a more detailed discussion see section IV. In a monetary union, these imbalances are not necessarily unsustainable, because the integrated monetary and banking system transfers savings to borrowers. However, because policy preferences are formed in national constituencies, these economic imbalances have political consequences. The political discourses in surplus countries praise their "competitiveness", while deficit countries ask their partners to consume more. What they do not understand is that they always speak to their own mirror image. Thus, by being subject to the same budget constraint, aggregate demand has become a "common European good" that affects all citizens in Euroland jointly and this entitles them to decide collectively how to manage them.

Because the policies pursued by one country generate externalities for others, it is a mistake to believe that member states can conduct their affairs in isolation. However, the central point here is that this interdependence results from the hard budget constraint of common money and therefore relates to net spending decisions. The interdependence does not exclude the possibility of shifting the national allocation of resources according to national preferences. For example, spending more on public goods like social services and financing this by taxes on private consumption shifts the *resource use* without affecting net *spending* aggregates. Thus, decisions about resource allocation can remain in the national policy domain without necessarily affecting the rest of the Euro Area. However, the aggregate net spending position (the Euro Area's aggregate deficit) is clearly of concern for all citizens, because it may affect interest and exchange rates, inflation and growth. The literature on public finance has insisted that the allocation function of government can be decentralized, but the stabilization function of public spending must be central (Musgrave 1956). Monetary union does not require convergence to a single social and economic model of resource use, but it needs coherence in the management of the externalities and interdependencies of public spending.

New political incentives in monetary union

When the distribution effects in an integrated economy are following the logic of zero-sum gains, voluntary policy cooperation between governments does not work because the gains obtained by one country inevitably imply (relative) disadvantages for others and each member state will seek to reap the benefits and avoid the costs. This leads to the typical and often lamented "national egoism". Fiscal policy in monetary union is an example for the uncooperative logic that emerges from common resource goods. Because money is the hard budget constraint, capital funds are scarce. If one government seeks to borrow more, other governments or the private sector need to borrow less; otherwise interest rates will go up and this will affect everyone.[22] Hence, governments have an incentive to free-ride on other governments by restricting the borrowing behaviour of their partners through the Stability and Growth Pact, while increasing their own deficits. This is what the newly elected President Sarkozy sought, when he went to the Euro Group meeting in July 2007 and asked for a "temporary" exemption of the EDP rules; not surprisingly, he was told off by the assembled Finance ministers. The Greek government of Prime Minister Karamanlis was more successful because it borrowed excessively without asking colleagues for approval. Sarkozy's virtue was his openness, Karamanlis' vice his secretiveness; but the incentives were the same for both.

The incentives for policy coordination and cooperation in European Monetary Union are very different from those prevailing in the early years of European integration, when distributional effects were dominated by positive-sum logic, meaning that due to European integration everyone was better off and no one worse off (so-called win-win situations)[23]. For example the advantages of forming a customs union, or the single market, could be calculated as the difference between trade-creating and trade diverting effects. When the net benefits were positive, a member state had clear incentives to join the union and play by the rules. The economic literature has described the differences between cooperative and non-cooperative incentives as strategic complementarities versus substitutabilities, or as *inclusive club goods* versus *exclusive common resource goods* (Cooper and John, 1988; Cornes and Sandler, 1996). While early European integration has followed the logic of cooperative club goods, monetary union has created competitive common resource goods, and these two different classes of public goods need very different kinds of governance. Club goods can be governed efficiently by relatively soft forms of policy coordination, essentially in order to overcome information asymmetries. In this context, the European Commission must make sure that national governments see the advantages they could obtain by cooperating. Common resource goods require much stronger forms of governance, because individual governments have incentives to do the opposite of what serves the Union. Binding rules with sanctions are then often proposed to ensure the stability and sustainability of an integrated economy and prevent damaging the common interest.

However, even binding rules may not provide the answers to all problems and an independent authority *supra partes* may be required to maintain the coherence of the economy. Rules are appropriate to ensure that governments act consistently over time, so that policy makers can be held accountable for sticking to their commitments (Kydland and Prescott, 1977). However, there are policy areas, where it may be necessary to react to a changing environment. In such situations, rules are too restrictive and do not allow optimal policy responses. In this case, a proper government is necessary that will act in the common interest of all.

[22] It does not matter for our argument whether the mechanism is crowding out in the capital market or raising interests by the central bank, which seeks to counteract inflationary demand pressures.
[23] See for example European Parliament 2010, which refers explicitly to win-win situations, without reflecting at zero-sum situations.

Macroeconomic management of the Euro Area is precisely the area, where a European Economic Government is required to implement stabilization policies effectively.[24] The reason is that macroeconomic stability is frequently and randomly disturbed by all kinds of shocks from within and from outside the economy and correcting action is required that responds to the specificity of those shocks. For example, a small demand shock may be dealt with effectively by discretionary monetary policy,[25] but as the recent global financial crisis has shown, a large shock needed active stimulus packages by governments world-wide, and these measures also needed to be coordinated with all major players, especially the US, China and Japan. It is clear that strictly following the policy rules of the Stability and Growth Pact would have been disastrous.

Rules cannot always be substituted to coherent policy action, but it has also become apparent that purely voluntary policy cooperation between governments does not work optimally either. Germany sought successfully to free-ride on the stimulating effects generated by spending elsewhere; the European stimulus was smaller than in other large economies like the USA, Japan and China and therefore prolonged the crisis unnecessarily.[26] Furthermore, international policy coordination suffers from the same collective action problems in the G20 (where Europe's complicated intergovernmental bureaucracy crowds out the rest of the world) that make efficient governance within the EU already so difficult.[27] Hence, the proper solution to these different forms of coordination failure is the institution of a European Economic government.

3. Europe's Economic Government

We can now tie together the arguments for an economic government and European democracy. This paper has made three points so far. First the traditional forms of voluntary policy coordination do no longer produce the desired results of welfare enhancement and this undermines the legitimacy of European integration. Secondly, the reason why intergovernmentalism no longer works efficiently in Europe are that monetary union has created common resource goods with zero-sum distributional effects and this creates incentives to behave uncooperatively. Thirdly, the solution to the efficiency problem is a common policy making authority, hence a European Economic Government. However, delegating more policy making authority to the EU level requires a leap in democratic legitimacy. A European Economic Government is only legitimate if European citizens can collectively, and not as separate national units, control the economic government that takes actions on their behalf. Because the only European institution representing European citizens is the European Parliament, the European parliament must authorize a European Economic government. Reforms of the economic governance that exclude the European Parliament as a law maker violate the democratic norms on which European integration is built. They betray Europe's deepest values.[28] How can a democratic European government be set up and what should it do?

[24] This is a classic topos in the economic literature of public finance. See Musgrave, 1956.

[25] Economists have debated heatedly in the 1960s and 70s whether monetary policy should follow rules or be discretionary. The argument has been settled in favour of the latter by making central banks independent and giving them clear policy objectives.

[26] In October 2008, the European Union adopted a recovery plan amounting to 1.6% of its GDP, compared to 5% in China and 6.55 % in the United States. See European Parliament 2010.

[27] In fact, the gridlock in the G20 is even worse than in Europe, because the G20 does not have the institutional strength of the EU. Not to mention the disastrous effects of so-called voluntary cooperation on the issue of climate change.

[28] Lisbon Treaties, TEU, art. 2.: „The Union is founded on the values of respect for human dignity, freedom, democracy, equality, the rule of law and respect for human rights, including the rights of persons belonging to minorities. These values are common to the Member States in a society in which pluralism, non-discrimination, tolerance, justice, solidarity and equality between women and men prevail."

The democratic revolution

A European Economic Government may be a revolution, but it does not require changing the Lisbon Treaties. As was mentioned above, a European Economic Government should logically evolve from the European Commission, which is endowed by the Treaty to serve the general interest of the Union[29] and has the necessary administrative services to do so. However, there is a danger that a Commission, which is primarily dependent on Council approval and with a President chosen by the heads of states and governments rather than elected by universal suffrage and the European Parliament, will become bureaucratic and tyrannical in the sense that it does not give citizens a choice over the policies they wish to see implemented. The proper way to remedy this danger is to make use of the provisions in the Lisbon Treaties, which give a right of approval to the European Parliament. This means using the "ordinary legislative procedure"[30] for passing regulations, directives and decisions with respect to the economic policies which affect all European citizens. Regulations would apply to all those policy areas, where the logic of common resource goods creates incentives for member states to behave uncooperatively. Directives are also important because, even if *designed* by the Economic Government, European policies will mostly be *implemented* by member states; directives have the advantage that they are binding for member states, but leave the choice of forms and methods how to achieve the common objectives to national authorities.

The proposal to strengthen the democratic "Mitbestimmung" of the European Parliament in matters of economic governance implies a shift in the balance of power between European institutions, but it does not require new institutions. The Lisbon Treaties provide a sufficient institutional framework. However, member states will certainly resist a democratic European government that can overrule them. The Franco-German Paper on a European Economic Government is perfectly clear in this respect. On four pages, it emphasizes three times the need of respecting the budgetary competences of national parliaments, without ever acknowledging that it is precisely this narrow understanding of national sovereignty (in contrast to the sovereignty of citizens, which has a long tradition in French political thought, from Rousseau to the Déclaration des Droits de l'homme et citoyen), which has contributed to the Greek crisis.

Let us be clear: If Europe's economic governance is to improve, the European Parliament cannot wait to be granted the right of having a greater say by member states. *Parliament must take this right.* It must risk conflicts, oppose the Council on important issues and deny the Commission approval, until these institutions heed attention to the will of the EP's majority. The English and French Revolutions are examples for Parliaments imposing their will on irremovable rulers; the German Revolution in 1848 failed because the Parliament in Frankfurt did not have the stomach to impose democracy on the Prussian tyrant – with terrible consequences for the next 100 years. Today, the violence of earlier European history is no longer acceptable. Fortunately, the Lisbon Treaties provide the framework for a democratic revolution, but the European Parliament must have the guts to stand up to nation state governments.

[29] Lisbon Treaty (TFEU), art 14: „The Commission shall promote the general interest of the Union and take appropriate initiatives to that end. It shall ensure the application of the Treaties, and of measures adopted by the institutions pursuant to them. It shall oversee the application of Union law under the control of the Court of Justice of the European Union. It shall execute the budget and manage programmes. It shall exercise coordinating, executive and management functions, as laid down in the Treaties. With the exception of the common foreign and security policy, and other cases provided for in the Treaties, it shall ensure the Union's external representation. It shall initiate the Union's annual and multiannual programming with a view to achieving interinstitutional agreements."

[30] TFEU, art.289: "The ordinary legislative procedure shall consist in the joint adoption by the European Parliament and the Council of a regulation, directive or decision on a proposal from the Commission. This procedure is defined in Article 294."

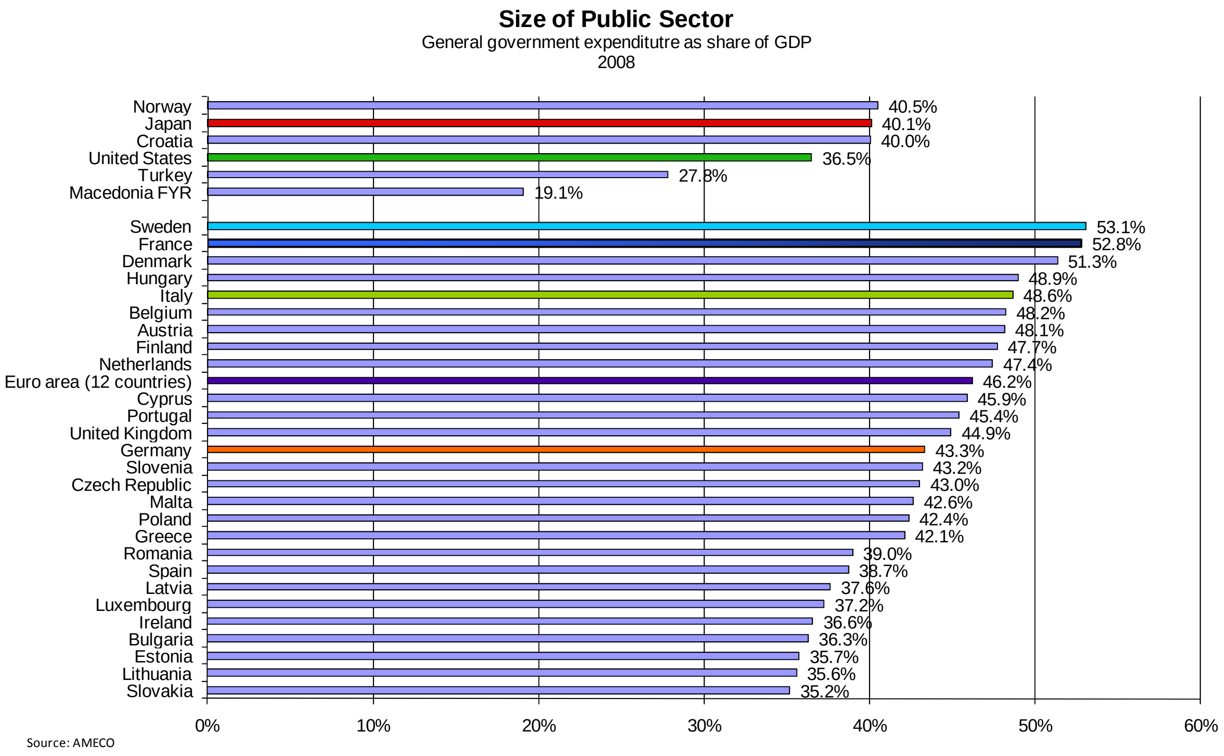
4. Democratic reforms of Europe's economic governance

This paper is about making Europe's economic governance more democratic. Rather than commenting on the undemocratic proposals under discussion among policy makers, I will now focus on how to strengthen the role of the European Parliament in the surveillance and implementation of coherent macroeconomic policies with respect to the three policy areas mentioned initially.

1. Strengthening surveillance over budgetary policy in the Stability and Growth Pact

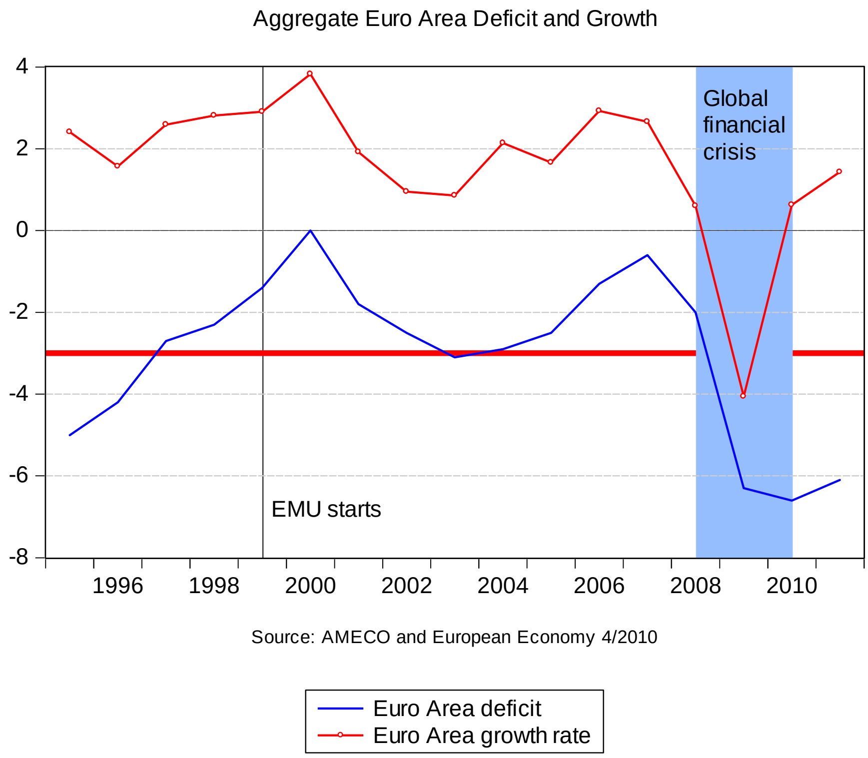
Budgetary policy remains a prominent area of national responsibility with respect to the allocation of resources. The European budget represents less than 1%, while in the European Union aggregate public spending amounted to approximately 45% of the Union's GDP before the crisis; with the reduction in GDP during the recession it has now risen to 50% (European Commission, 2010a). Sweden and France used to realize the highest share 8%-points above, Slovakia, Lithuania and Estonia the lowest with 10 points below average. See Figure 1.

Figure 1



Hence, there can be no question of a large centralized federal budget. The allocation of resources to public goods is essentially a national task and must reflect national political preferences. However, as discussed above, the budgetary positions of member states have external effects on the euro, and therefore defining the aggregate budget position must be a common European concern. If aggregate fiscal policy is too accommodating, it may cause rising interest rates and inflation; if it is too strict, it may inhibit growth and job creation. Nevertheless, national budgets have only a marginal impact on total public borrowing in the Euro Area;[31] what matters for macroeconomic stability is the aggregate budget position of all member states. Figure 2 shows the close correlation between the aggregate deficit and the growth rate in the Euro Area. During the severe recession in 2008-10, the 3% target of the EDP was suspended, but returning to fiscal discipline after the crisis seems slow and difficult. Although economic growth has now become positive again, it remains low and the deficit is not returning into the below-3% range soon. As the Commission (2010) has pointed out, discretionary measures, which were taken during the crisis, have had structural effects that will persist even after durable growth resumes.

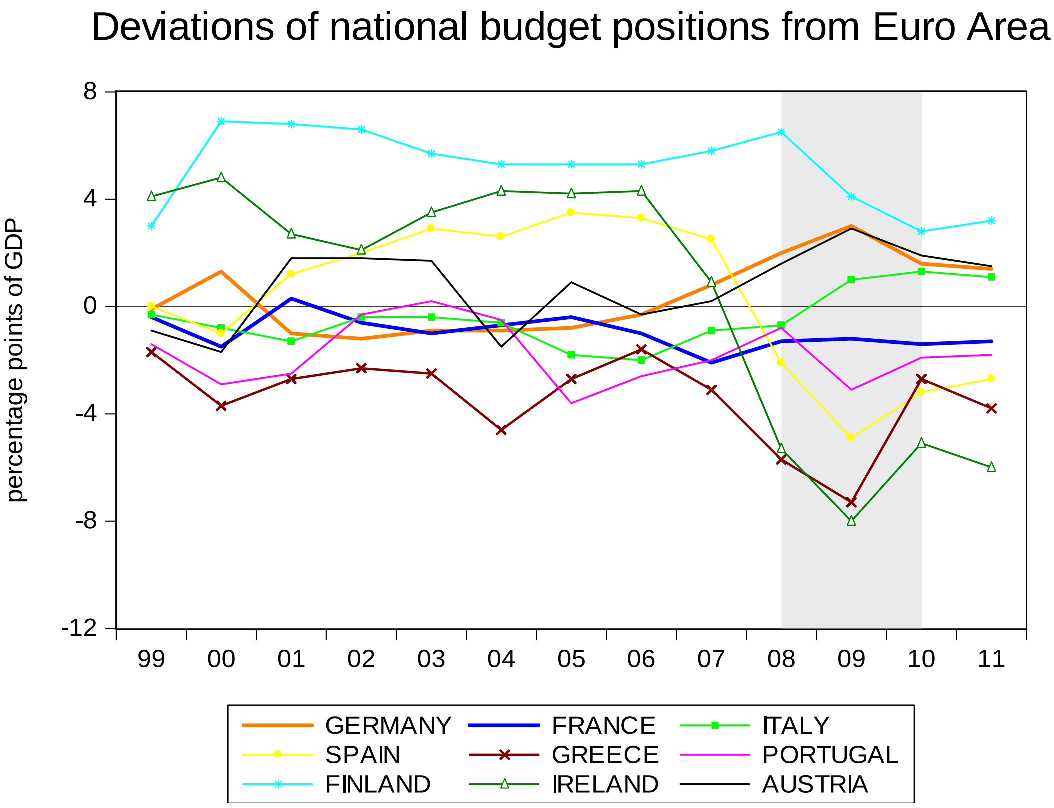
Figure 2



Because the aggregate fiscal position is dependent on each member state's contribution, the surveillance of national budget policies is important. Figure 3 shows the deviation of relevant member states from the average of the Euro Area. France, Greece and Portugal have always borrowed more in terms of GDP than the aggregate Euro Area, Finland always less. Germany in 2006 and Italy in the crisis year 2008 have switched position from super borrower (more than average) to super consolidator (less than average). By contrast, Ireland and Spain have seen a dramatic deterioration in their performance at the outbreak of the global crisis in 2007/8. Thus, the actual fiscal policies pursued have varied greatly across all member states, even if they are interdependent.

[31] Obviously the impact of large member states is stronger than that of small states.

Figure 3



A number of reasons may explain these different performances. If the excess borrowing is structurally stable, like in Greece or Portugal, it could reflect deliberate catch-up policies, given that these are economies with low per capita income. However, that is not the case. The share of public investment in Greece (2.9%) and Portugal (2.4%) was not significantly different from the Euro Area (2.8), contrary to Spain (4.4%) and Ireland (4.5%). Hence, one must conclude that in Greece and Portugal governments borrowed to finance consumption, which is not helping much to accelerate growth. By, contrast, in the two other catch-up economies, in Spain and Ireland, rapid growth has generated the income which caused budget surpluses. One should, therefore, take growth differentials into account when assessing the sustainable budget positions of member states, rather than treating all member states with the same rule under the SGP. This shows that designing the appropriate fiscal policy requires a least some degree of discretion.

Thus, it is reasonable that reforms of Europe's economic governance focus on how to "reinforce compliance with the Stability and Growth Pact and deeper fiscal policy coordination" (European Commission, 2010). However, as our discussion above has shown, there are significant problems with the proposed reforms. First, they are purely intergovernmental (with the Commission as handmaiden). Secondly, the proposals seek bureaucratic and not democratic procedures for surveillance and penalties. The ECB even wishes to delegate fiscal policy to "an independent European fiscal agency", as if the democratic principle "No taxation without representation" had no meaning in Europe. We are heading for a pre-democratic *ancien régime*. Thirdly, there is no intrinsic mechanism that can ensure the implementation of bureaucratic policy surveillance, because national parliaments alone have the legitimacy to decide on taxes, spending and debt. There is no guarantee that they will do what would be optimal at the European level, because governments respond to the partial interests of their constituency. It is therefore highly doubtful that the proposed reforms of Europe's economic governance will avoid future crises. A different approach is needed.

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

- The Economic Guidelines will become a Union legal act that defines the general policy orientations and decides the optimal borrowing requirement for the Euro Area, i.e. the aggregate budget deficit which is considered consistent with the economic environment (business cycle) and the structural requirements of the European economy (public investment, aging etc.). On the basis of a Commission proposal, the Council together with the European Parliament will pass a directive that will define the aggregate amount of borrowing permits, which give public authorities the right to issue new debt, and will allocate these permits to member states.

- The European Parliament will have an active role in the formulation of the desirable aggregate policy stance. Art. 135 of the TFEU requests the Council "*to set out economic policy guidelines for [member states in the Euro Area], while ensuring that they are compatible with those adopted for the whole of the Union and are kept under surveillance*". *A priori*, this excludes the Parliament. However, who would object that the Council, with reference to art. 289 and 290, would stipulate that through an ordinary legislative procedure the Economic Guidelines will define the desirable aggregate deficit of the Euro Area? Political will is the key to such reform.

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

- Some member states may wish to borrow more than they have been authorized. The coherence of fiscal policy can only be maintained, if the excess borrowing by some countries is compensated by less borrowing in other countries. Hence, there must be the possibility of horizontal transfers of the borrowing permits. Inspired by tradable pollution permits, such transfers could be traded in a specially set up market. Table 1 gives an indication of the size of such transfers based on the actual borrowing of the Euro Area in 2009.[32] Total borrowing was € 574.7bn, i.e. 6.5% of GDP. Assuming that this was the desirable amount of aggregate borrowing in the crisis situation, Germany's borrowing share was only half of its GDP weight and Spain's nearly double. With the tradable permit system, the request of excess borrowing by Ireland, Greece, France and Spain could have been authorized by unused permits from Germany, Italy, the Netherlands, Finland and Austria.

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

Table 1 - Deviations from aggregate borrowing requirements

	%-Shares in:		Difference	
	Borrowing	GDP	% of GDP	€ bn
Germany	14.0	27.3	-13.3	-76.6
Italy	13.9	17.0	-3.1	-17.6
Netherlands	4.7	6.3	-1.6	-9.1
Finland	0.9	2.0	-1.1	-6.4
Austria	2.1	3.0	-0.9	-5.3
Belgium	3.5	3.8	-0.3	-1.9
Cyprus	0.2	0.2	0.0	-0.2
Slovakia	0.7	0.7	0.0	0.0
Slovenia	0.4	0.4	0.0	0.1
Portugal	2.2	1.8	0.5	2.8
Ireland	3.6	1.5	2.0	11.8
Greece	5.3	2.6	2.7	15.8
France	28.0	22.0	6.0	34.6
Spain	20.5	11.5	9.0	52.0
Euro Area (13)	*100.0*	*100.0*	*0.0*	*0.0*
Total EA €bn	574.7	8908.5	6.5%	

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

5. Competitiveness surveillance and the correction of economic imbalances

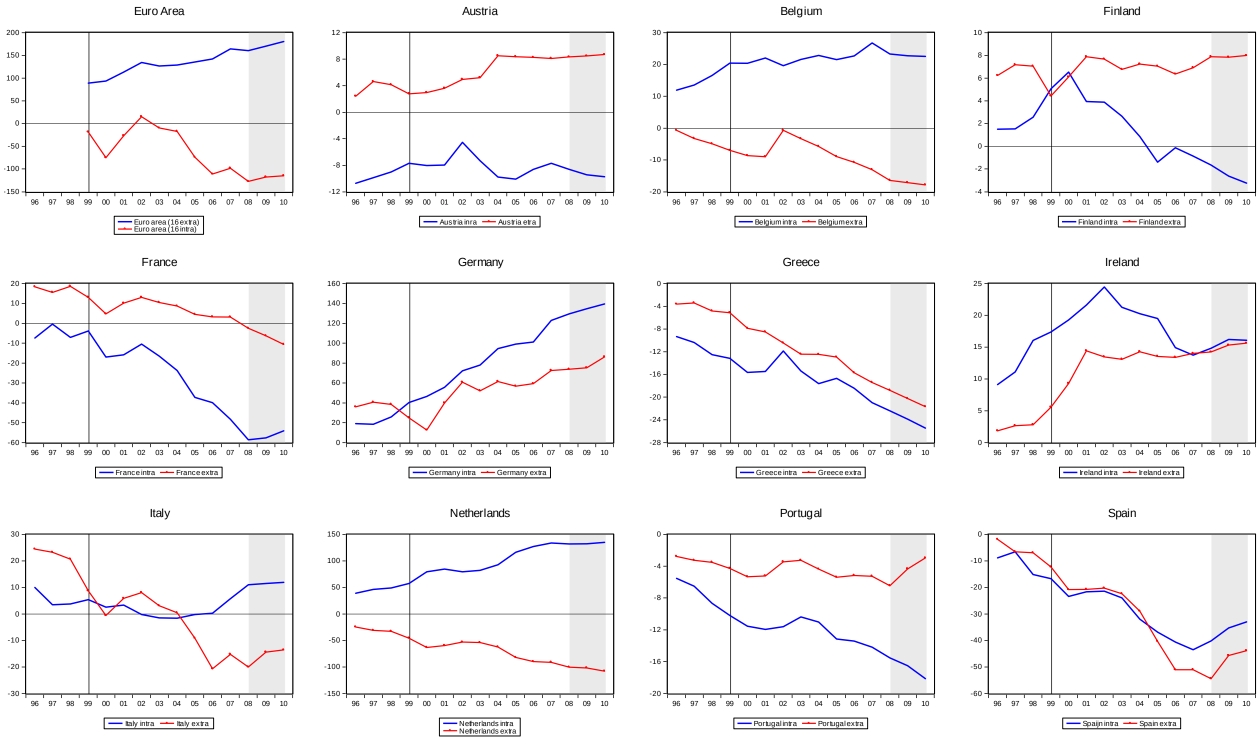
The recent crisis has brought to light the substantial heterogeneity between the Euro Area economies. This should hardly surprise anyone who has accepted that member states as different as Germany, Greece, Slovakia and Estonia share the same currency. In fact, economic heterogeneity is not an argument against monetary union. Regional divergences within the United States, Canada, and India are probably higher than in Europe. The stability of a common currency is able to accelerate catch-up growth by providing a favourable framework for investment and in the long run this should help with the real convergence of income. However, it is crucial that the behavioural incentives for economic agents do not jeopardize the functioning of the Euro Area. This requires that economic agents in the private and public sector are aware of which developments are leading to a stable development and which do not. In other words, serious imbalances between member states, but also between economic sectors, need to be avoided.

The Greek crisis has finally alerted policy makers (and their submissive intellectuals) to the dangers that are caused by persistent divergences in price and cost developments in the Euro Area. Nevertheless, the public debate in Europe has a tendency to reduce the issue to current account imbalances. As I have argued in my last paper to the Economic and Monetary Affairs Committee (Collignon2010), this is misguided because there are “good” and “bad” current account deficits or surpluses according to the overall economic strategy pursued by member states and because the savings-investment balance for individual member states has become irrelevant in monetary union. A different approach to assessing competitiveness focuses on trade imbalances. Figure 4 shows that this, too, can be misleading. Only Germany has a clear tendency of improving its trade deficits within and outside the EU and this can be interpreted as a sign of improved competitiveness. The Netherlands increase net exports to the EU, but net imports from the rest of the world have fallen. Finland and Ireland have a deteriorating trade balance within the EU, but they are stable surplus countries with the rest of the world. The opposite is true for Belgium and Italy. Portugal has also a deteriorating trade position in the EU, but is a *stable* net importer from outside the Union. With a national currency, such position would be unsustainable, in monetary union this is no problem because Portugal cannot run out of foreign reserves. Only in France, Greece and Spain is there a clear tendency for deteriorating trade balances and this could indicate losing competitiveness. It is instructive to note that Germany, the only clear “winner” in all trade balances, has persistently lowered its unit labour costs relative to the average of the Euro Area, while Greece, Portugal and Spain had the highest increases. However in France, unit labour costs remained close to the Euro Area average and the trade position deteriorated nevertheless.[33] These facts indicate that price and cost developments are not the only factor that determines internal imbalances. Trade balances do respond to relative costs, but also to demand in different markets. German surpluses may reflect a lack of domestic absorption and French surpluses an excess. For example, the stagnating wage developments in Germany cause below average consumption (because workers have less purchasing power), so that correcting the German surplus by increasing wages would go a long way towards improving European disequilibria. In conclusion, these data present a very mixed and differentiated picture about “competitiveness” in the Euro Area. Assessing competitiveness requires a broader picture than current account imbalances.

[33] For details see my discussion in Collignon 2010 and my analytical paper 2010a.

Figure 4

Trade Balances in the European Union: Intra and Extra EU Trade
bn euros



European authorities are aware of these complexities. Consistent with its policy brief, the ECB (2010) has focused on price and cost competitiveness indicators in its proposal for reforming the governance of the Euro Area. Taking a wider angle, the European Commission (2010) has suggested monitoring macroeconomic imbalances through a scoreboard that would "*reflect, inter alia, developments in current accounts, net foreign asset positions, productivity, unit labour costs, employment, and real effective exchange rates, as well as public debt and private sector credit and asset prices. It would appear particularly important to detect asset price booms and excessive credit growth at an early stage to avert costly corrections of fiscal and external imbalances at a later stage. This analysis would form the basis for the formulation of the recommendations for preventive or corrective measures in the Member State(s) concerned.*" In principle, these are excellent ideas and they describe the proper and natural task for any economic government. The question is: what can member states do about European competitiveness?

Economic competitiveness is a confused notion. Paul Krugman (1994) has famously argued: "*The view that nations compete against each other like big corporations has become pervasive among Western elites. (...) As a practical matter, however, the doctrine of "competitiveness" is flatly wrong. The world's leading nations are not, to any important degree, in economic competition with each other. Nor can their major economic woes be attributed to "losing" on world market. Yet, theorists of competitiveness, make seemingly sophisticated arguments, most of which are supported by careless arithmetic and sloppy research. Competitiveness is a seductive idea, promising easy answers to complex problems. But the result of this obsession is misallocated resources, trade frictions and bad domestic economic policies.*" In Europe, the danger is that sophisticated score boards, political targeting and intergovernmental coordination will produce "bad policies", which will have as little success as the Lisbon Strategy in 2000. The damage would be enormous.

The confusion results largely from the fact that companies compete in markets, but governments try to support them, mainly for employment and revenue purposes. In a social market economy, the role of government is to focus on macroeconomic conditions that foster growth, support price stability and reduce unemployment. However, because the Euro Area has no economic government, there is no institution that can define a consistent set of macroeconomic policies. Instead member state governments focus on microeconomic manipulations. They support "their" companies against those of the competitors from other member states. In his innocence, Nicolas Sarkozy gave a beautiful example when he declared: "It is justifiable if a Renault factory is built in India so that Renault cars may be sold to the Indians, but it is not justifiable if a factory of a certain producer is built in the Czech Republic and its cars are sold in France". Of a similar nature, though less crude, were Germany's state guarantees for Opel. These state interventions undermine European integration, but they only do so because political integration is not going far enough.

In principle, competition policy should prevent member states from mutually damaging each other and no doubt the European Commission and the European Court of Justice have often defended the common interest successfully. However, the incentives for member states to distort the single market by political action persist. President Sarkozy has eliminated the objective of "fair competition" from the Lisbon Treaty, while Germany accumulates substantial trade surpluses at the expense of its partners. What kind of competitiveness can one expect, when fair competition is not an objective for European policy?

In fact, one must distinguish two concepts of competitiveness. One concept, usually defended by Germany, is based on improving efficiency and productivity and on companies competing on the quality of products. The policy implication is that the other member states should emulate the German model. No doubt, increasing efficiency, eliminating bureaucratic red tape and eradicating corruption would do a lot of good in many member states. Unfortunately, the European Union is not exactly leading by example and Germany' *Vorsprung durch Technik* cannot become a universal model. The alternative concept is based on relative cost competitiveness. By undercutting competitors in prices and costs, one can increase market share. This concept of competitiveness cannot be generalized either, for the gain in market share for one necessarily implies the loss for someone else. Of course, the two forms interact: higher productivity leads to cost advantages, and larger market share can improve productivity through economies of scale. Thus, unless one clarifies the concepts, discussions about "surveillance of competitiveness" are meaningless.

European policies can support the first concept of qualitative competitiveness, but not the second without distorting the single market. Improving Europe's economic efficiency necessitates a European government that can act in the common interest and avoid that member states seek to gain at the expense of the rest of Europe. The Lisbon Strategy and now the Europe 2020 agenda were seeking to improve competitiveness by raising productivity, research and development. However, the allocation of private investment follows the market logic of relative cost advantages. Hence, cost competition is primordially in the domain of firms; governments can control this variable only indirectly by setting tax and social charges, by granting subsidies and imposing administrative burdens on private agents. This is how member states compete with each other, although these administrative interferences with market dynamics have external effects. As was discussed above, such externalities warrant an economic government that can overrule the special interests of member states.

A European economic government must be able to prevent uncooperative behavior by member states and improve the general conditions of efficiency in the Union. Market intervention by a European government can be justified to remedy distributive distortions on grounds of fairness and social stability, but it can also distort the level playing field for fair competition, which is the foundation of Europe's internal market. There are no easy answers as to what the right policy is, and this is precisely why more democracy and less expert rule are needed. Policy preferences may change. Implementing a particular policy is only legitimate after a European-wide democratic debate has yielded a policy consensus that is supported by the majority of European citizens. These policy debates must take place in and through the institutional framework of a representative democracy that is capable of linking words to actions, because parliamentary debates are followed by votes which give authority to governments. Hence again, the proper solution for European economic imbalances is to involve the European Parliament in the decision making process, because the European Parliament is the only representation citizens have at the European level.

6. The design of a euro area framework for crisis management

The Greek crisis has taught two things: First, Europe's intergovernmental governance cannot prevent major crises that threaten the existence of the euro and ultimately European integration. Second, partial interests of member state governments can make the crisis worse. Had the EU responded in the early phase of the crisis with the same boldness it eventually gathered by stitching together a rescue package and setting up the *European Financial Stability Facility* on 9 May 2010, a lot of damage could have been avoided. The reason why this did not happen is, of course, that at least one member state government blocked the necessary collective action. What lesson can be learned from this coordination failure?

The reform proposals by European authorities recognize that more common action is desirable and rightly emphasize the need to avoid generating moral hazard. However, moral hazard is created when the knowledge of a rule – here the knowledge that big debtors will be bailed out – creates an incentive to reap partial gain for which others bear the cost. Hence, moral hazard has two logical components: (1) there must be several independent actors, and (2) they must have knowledge of an (implicit) policy rule. It was argued above that rules are not an appropriate method to deal with situations, which need discretionary action to insure the welfare of all citizens. Clearly, a crisis is such a situation. Hence, setting up a European economic government that can act with measured discretion in the collective interest of all European citizens is the simplest and most efficient solution to the moral hazard problem. It allows rapid unified action and does not depend on *ex ante* commitments to policy rules.

However, conferring the power of dealing with a crisis to the European level raises again the issue of democratic legitimacy. The intergovernmental solution proposed by the Franco-German paper, does not solve the fundamental problem, why governments should agree to policies imposed on them from outside. Hence, other than giving reassuring words to "manage perceptions" nothing will be done to improve Europe's way of dealing with emergencies. The idea to suspend voting rights for "sinning member states" is, of course, a gross violation of democratic principles, for it would deprive the citizens living in the excluded jurisdiction of any democratic representation. The ECB is right to reject such proposition. Nevertheless, the alternative of charging the Commission, which is clearly a more efficient solution, implies a far-reaching transfer of power. Such conferral is compatible with the Lisbon Treaties, if the crisis management takes the form of regulations and directives by the Commission, which are subject to the approval by the Council and the European Parliament. The three European institutions would therefore carry the full legitimacy of citizens' representative bodies and would also take into account the unquestionable concerns of member states' governments. The justification of policies *ex post* can lead to the revocation of a democratically elected Commission, following the elections of the European Parliament, if it failed to heed the preferences of European citizens.

Conclusion

This paper has argued that the problems of coordination failure and the insufficient enforcement of common policy rules that have caused the Greek crisis are due to a lack of democracy at the European level and not to a shortcoming of technocratic procedures. Unless reforms take this democratic dimension seriously in consideration, future crises are inevitable. An economic government for Europe must arise from the functions which the Lisbon Treaty assigns to the European Commission, and the necessary democratic surveillance can only be exercised by the European Parliament, which is the only institution that represents all European citizens collectively. By making full use of the new opportunities in the Lisbon Treaty, Europe's crisis could actually contribute to the deepening of European Integration.

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