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Economic Governance in the European Union: Possibilities and Problems of supranational policy coordination*

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1. Introduction

In a book on globalisation, I found the interesting comment that Sao Paulo is sometimes mentioned as 'Germany's largest industrial city' (see Dicken 1992)! Taking the vast amount of German Foreign Direct Investment (FDI) in the Sao Paulo region and the number of jobs involved into account, this may well be true. However, such a statement does not adequately portray the most important facet of the process of globalisation: Contrary to the suggestion of an increasingly rootless capital spreading without any systematic pattern across the globe, the process of economic globalisation really evolves along the line of regions of intense and ever growing economic integration[1]. From a European perspective, the process of European integration is definitely the most important aspect of globalisation, which has reached a first climax of 'positive' integration in the sense of the creation of union-wide institutions with monetary unification and the establishment of a European Central Bank (ECB) in 1999.

It was particularly this last step, which has sharpened the view for the need of a comprehensive system of economic governance in the European Union (EU).[2] By 'governance' in contrast to 'government' a process of continuing cooperation of national actors and the coordination of national or even sub-national (e.g. regional) economic policies is meant (see e.g. Rosenau/Czempiel 1992, Gilpin 2001: 391ff.).

Before explaining the system of economic governance in the EU (part 4) and taking a look ahead (part 5), let me start with some clarifying principles of the provision of public goods in general (part 2) and of European public goods in particular (part 3).

2. The principle problems of public good provision in an integrating world

Economic policy can sensibly be analysed in terms of the provision of public goods[3]: social security or infrastructure as well as economic or price stability, fiscal or environmental sustainability, public education, lighthouses or public utilities etc. However, due to the peculiar characteristics of public goods (as opposed to private

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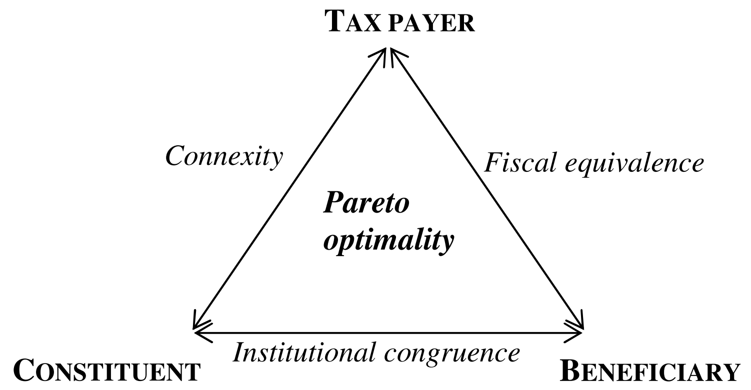
1 "As some of the extreme advocates of globalization recognize, the world economy is far from being genuinely 'global'. Rather trade, investment and financial flows are concentrated in the Triad of Europe, Japan and North America and this dominance seems set to continue" (Hirst/Thompson 1999: 2)

2 Reading the European Commission's White Paper on European governance (European Commission 2001) one gets the impression that addressing European governance is merely a question of improving the apprehension of policy making at the EU level by the European people ("The goal is to open up policy-making to make it more inclusive and accountable"). Out of five principles of 'good governance' only one ('Effectiveness') is related to economic policies ends.

3 see e.g. Reinecke (1998: 85ff.) or Conybeare (1984).

goods) – i.e. non-rivalness in consumption and non-excludability – the task of maximising social welfare by providing public goods (i.e. the economic principle of efficiency) becomes unmanageable: On the one hand, it is impossible to construct anything like a consistent and uncontroversial social welfare function in heterogeneous societies (Arrow's Impossibility Theorem)[4], one the other hand, financing public goods is prone to free-riding behaviour.[5] Both problems are exactly at the bottom of public instead of private goods provision (which would not occur under these circumstances), yet they include that the provision of public goods – i.e. the amount and specific nature – will always be torn between vested individual, class or other interests. In democratic societies, this 'battle' or choice takes the form of elections, putting the electoral processes – the electoral system as such as well as agenda-building and agenda-setting-processes – at centre stage of economic policy.

Figure 1: Three dimensions of goods provision



Note: Under the assumption of connexity, institutional congruence and fiscal equivalence, the provision of goods will be pareto-optimal. This is the ordinary assumption of private goods provision as beneficiary, payer and constituent are only three dimensions of one individual actor: the consumer.

The process of globalisation in general and of European integration in particular aggravates the problems of public goods provision at national levels: firstly, external effects such as competitive aspects of social security systems or spill-over effects of fiscal or monetary stabilisation policies affect adversely the connection between the electorate (or constituency) and the beneficiary or they increase the social costs of economic policies. Secondly, economic actors get a second option: in closed economies, they can use the 'voice-option' in the electoral process, yet have to accept the electoral outcome finally. In a growingly open economy, some actors – those with the least cost of mobility – may also use the 'exit-option' if public goods provision does not conform with their preferences and, in some cases, even the 'dirty' exit-option which combines

[4] Which includes a frustration of individual preferences or, as in fig. 1, the breaking of institutional congruence. As fig. 1 shows, this results in a pareto-inefficient supply of public goods.
[5] Which includes, as in fig. 1, a rupture between the individual consumer (of public goods) as constituent and as tax payer (i.e. the connexity) and the non-existence of fiscal equivalence.

the possibility of consuming public goods in a country without providing resources for the provision of such public goods. The result of both problems is either a deficient supply of public goods – e.g. the level of social security will be reduced below what a society would like to consume if globalisation or regional integration would not have taken place or stabilisation policies will not be used effectively because every country is waiting for the 'locomotive function' of the other countries – or a 'gap of justice' as the less mobile actors – particularly workers and the less skilled – will be increasingly burdened.

In this context, the sometimes alleged positive effects of the 'competition of economic, social and tax systems' in a growingly global world (the 'Tiebout proposition'[6]) ignores the potential rupture between tax payer and beneficiary – what is called 'fiscal equivalence' – and must therefore be taken very critically.

3. **European public goods as a normative concept**

To cure the problems of public goods provision at least to the extent caused by European integration, a cooperation of economic policy actors and a harmonization of policies in the areas of fiscal, social, budgetary and probably even wage policies is necessary. In the light of a variety of path-dependent, historically grown institutional systems in the now 25 EU members states, harmonisation cannot be translated as 'standardisation', but rather a benchmark-based establishment of functional equivalence of different systems preventing dumping effects from happening. Taking the almost complete absence of financial resources at the EU-level and the lack of a conscious European public opinion for granted (see Abromeit 1998; Etzioni-Halevy 2002), the provision of European public goods cannot take place in the form a hierarchical cooperation – i.e. government in a 'European Republic' – but must be established as a process of multi-level cooperation with most legal and financial resources and the political legitimacy still at national (or even sub-national) level – i.e. governance in the above-mentioned sense.

Monetary unification with the provision of a single currency and the hierarchical cooperation of national central banks in the European System of Central Banks (ESCB) headed by the ECB must, therefore, rather be seen as the exception to this rule than as a viable blue print for a system of European economic governance. Although hierarchical or hegemonial cooperation is often believed to be more stable than the cooperation among equals (see Keohane 1984), this seems to be no viable option in the European Union where most crucial decisions still have to be made unanimously (and decision making is rooting in national interests).

4. **Fragments of a European economic governance system in reality**

4.1 The Open Method of Coordination (OMC)

The coordination of economic policy areas among equals keeping financial resources at their disposal is called 'Open Method of Coordination' (OMC) in EU reality.[7] This

[6] see Tiebout (1956), Epple/Zelenitz (1981) and, applied to European Integration, Berthold/Neumann (2001).

[7] Although the OMC has only recently been established by the so called 'Lisbon strategy', the multilateral surveillance procedures of earlier EU programmes (i.e. the employment chapter of

method is used for the coordination of economic policies in general and finds its expression in the 'Broad Economic Policy Guidelines' (BEPG) passed each year after a long, reflexive process of discussions among the European Commission (EC), the European Parliament (EP), the European Council, and the Social partners (see tab. 1). After the Amsterdam revision of the Treaty of the European Union has accepted EU-responsibility for employment issues, the OMC has been expanded to employment policies in what is called annual 'Employment Policy Guidelines' (EPG) being also passed after an equally long process of communication and initiating individual 'National Action Plans' for each EU member state.[8] Two more governance processes using the OMC should also be mentioned:

° The 'Cardiff process' coordinates structural reforms and liberalisations on goods, service and financial markets by which so called 'meritoric' public goods[9] are successively being transformed into private goods (e.g. in telecommunications, public utilities such as electricity and water supply, etc.).

° And, finally the 'Cologne process' is supposed to organise a 'macro dialogue' between the ECB (responsible for monetary policy), EU finance ministers (ECOFIN responsible for fiscal and budgetary policies) and the social partners (responsible for wage policies).

The OMC is characterised by a lack of financial sanctions in case of non-compliance but relies on 'peer and public pressure' (moral suasion) – that is why it is sometimes called 'soft coordination'. As most proposals (passed under OMC) are rather broad in nature or set only very long term guidelines or targets (such as the maximum ratio of long term unemployment in each member country of the EU in 2010 or a benchmark for participation ratios), the efficiency of the OMC is difficult to test or certify (see e.g. Borras/Greve 2004). To my eyes, in the moment it rather serves as a tool to keep economic policy debates within EU member states on supply side orientation[10] than to initiate anything that could sensibly be called cooperation.

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the Amsterdam treaty) can be summarised as a variant or predecessor of the OMC (see e.g. Hodson 2004).

[8] European employment policy under OMC is coordinating national policies that neither interact nor are interdependent (see tab. 4). Therefore, coordination is not necessary in order the enhance effectiveness of national policies but rather means the harmonisation of preferences, standards or the exchange of tacit knowledge. In this respect, coordination can be regarded as something in its own right but cannot be derived by economic rationality as I tried to expose above.

[9] Meritoric public goods are such goods that, for whatever reason, have been supplied exclusively by public authorities although they do not bear the characteristics of pure public goods (see Musgrave 1959).

[10] This is particularly achieved by the BEPG and the EPG and has been investigated along the lines of the 'Cardiff process' (see Foden/Magnusson 2002).

Table 1: The process of Economic Governance in the European Union

Actor / Field of action	EU Commission	Council of Ministers	Economic Committee; Employment Committee	Social partners	ECB	European Parliament	National Governments
Employment Policy • Luxemburg process • Cardiff process • Cologne process	*Drafts:* • Economic Policy Guidelines (EPG) • Annual Employment Reports • Cardiff reports *partcipates:* • Macro-dialogue	*Decides on:* • Economic Policy Guidelines (EPG) • Annual Employment Reports • Cardiff reports *participates:* • Macro-dialogue	*comments on:* • Economic Policy Guidelines (EPG) • Annual Employment Reports • Cardiff reports *participates:* • Macro-dialogue	*comments on*: • Economic Policy Guidelines (EPG) • Annual Employment Reports *participates:* • Macro-dialogue	*participates:* • Macro-dialogue	*comments on:* • Economic Policy Guidelines (EPG) • Annual Employment Reports	*drafts:* • National Actions Plans (NAP) • Nationale Cardiff reports
Broad Economic Policy • Coordination • Budgetary Policy (ESGP)	*Drafts:* • Broad Economic Policy Guidelines (BEPG) • Annual Economic Reports *surveys:* • Excess Deficit Procedure	*Decides on:* • Broad Economic Policy Guidelines (BEPG) • Annual Economic Reports *decides on:* • Excess Deficit Procedure	*comments on :* • Broad Economic Policy Guidelines (BEPG) • Annual Economic Reports	*comments on:* • Broad Economic Policy Guidelines (BEPG) • Annual Economic Reports		*comments on:* • Broad Economic Policy Guidelines (BEPG) • Annual Economic Reports	*drafts:* • Stability and Convergence programmes

The macro-dialogue of the 'Cologne process' – through all the documents of the EC, EP and council of ministers taken as the prerequisite for an environment favourable for growth and employment – in its present institutional design seems to be no more than a 'chat box' without traceable consequences for policy behaviour (see Heise 2002)[11]. A comparison of fiscal and monetary policy stances – a growth oriented policy mix is the proclaimed aim of the Cologne process – between 2000 and 2004 indicates (see tab. 2), that both policies are set in a more restrictive mode in the Euro-Zone than in the United States. This result, which copies the divergent policy orientations in the United States and Germany at the end of the last decade (see e.g. Lombard 2000; Semmler 2000) and is even more pronounced if the development after the terror shock of 9/11 is portrayed instead of comparing annual averages across slightly divergent business cycles, has not benefited price stability in the Euro-Zone but must be seen as being detrimental to growth and employment in Europe. However, the performance indicators of the non-EMU countries at least suggest that a restrictive policy stance is not the exclusive result of an inefficient economic governance within the Euro-Zone.

Table 2: Macroeconomic performance of the Euro-zone, USA, and the non-EMU countries Sweden, Denmark and the UK in 2000 – 2004

	Euro-Zone	USA	DK	S	UK
GDP[1]	1,6	3,5	1,5	2,2	2,5
GDP-Deflator[1]	2,0	2,2	2,2	1,8	2,6
Structural budgetary balance[2]	-2,4	-3,3	1,4	1,1	-1,2
Total budgetary balance[2]	-1,8	-3,0	2,0	1,8	-0,6
Short term real interest rate[3]	1,3	0,5	0,9	2,0	1,9

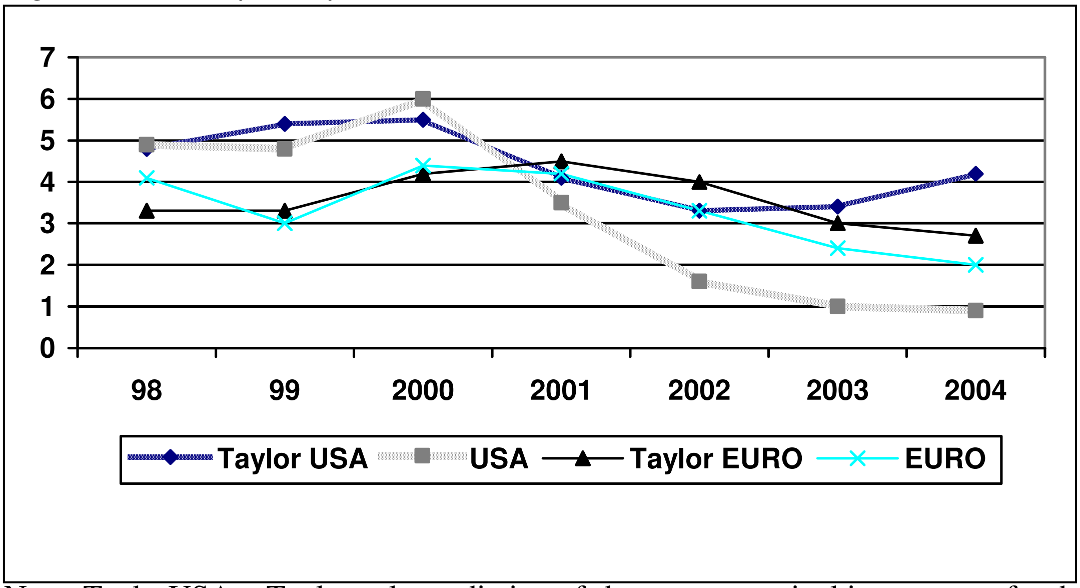
Note: [1] = average annual growth rate; [2] = average % of GDP; [3] = average %
Source: European Economy 2004

Taking monetary policy separately, the restrictive and growth-damaging stance of ECB policy will be evident if it is compared to US monetary policy. In fig. 2 actual (nominal) short-term interest rates are compared to interest rates generated by a Taylor-rule[12]. Although monetary policy in the Euro-Zone seems to follow the Taylor-rule predictions quite closely, US monetary policy shows how to react appropriately to an external shock. And in fig. 3, where the difference in monetary policy orientation is depicted against the different growth performances, the detrimental effect of restrictive monetary policy within the Euro-Zone (with a time lack of one period) is easy to detect. To be

[11] For a similar, yet more moderate interpretation see Watt/Hallwirth (2003) and Allsopp/Watt (2003).
[12] John B. Taylor (1993) established a simple rule that was able to explain (ex ante) and predict (ex post) monetary policy. The simple Taylor-rule used here is $i_T = i^* + \Delta P_t + 0{,}5$ [(inflation gap) + (output gab)]; with i* as the (real) equilibrium level of short-term interest rate (= 2%) and ΔP_t as the tolerated inflation rate.

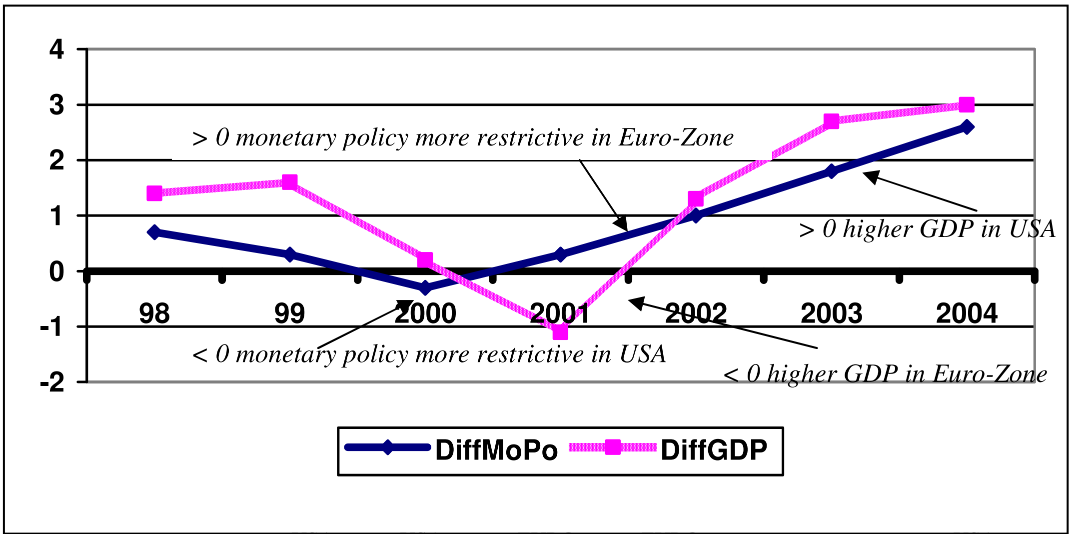
very explicit: this result is not caused by European monetary integration but proves the ineffectiveness of the European governance process with respect to macro-economic coordination.

Figure 2: Monetary Policy in the United States and the Euro-Zone 1998 – 2004



Note: TaylorUSA = Taylor-rule prediction of short-term nominal interest rate for the United Sates; TaylorEURO = Raylor-rule prediction of short-term nominal interest rate for the Euro-Zone; USA = short-term nominal interest rate in the United States; EURO = short-term nominal interest rate in the Euro-Zone
Source: OECD – Economic Outlook No. 75, 2004; IMF – World Economic Outlook 2004; own calculations

Figure 3: Monetary Policy and growth performance; United States and the Euro-Zone 1998 - 2004



Note: DiffMoPo = ($[i_T^{USA} – i_{Ac}^{USA}] – [i_T^{EURO} – i_{Ac}^{EURO}]$); DiffGDP = GDP^{USA} - GDP^{EURO}; mit i_T = Taylor-rule based interest rate; i_{Ac} = actual nominal interest rate
Source: OECD – Economic Outlook No. 75, 2004; IMF – World Economic Outlook 2004; own calculations

4.2 The European Stability and Growth Pact (ESGP)

Only in one policy area (see tab. 3), namely budgetary policy, a different method of coordination – 'hard coordination' called – has been established: the 'European Stability and Growth Pact' (ESGP) restrictively coordinates national budgetary policies to ensure 'zero deficit budgets' as fiscal policy rule in the European Monetary Union. Principally, the ESGP does not rely on 'moral suasion' but is based on a clear mechanism of material sanctions in order to 'tie the hands of the single nations'. Ironically, it was the German government which believed this kind of 'hard coordination' to be necessary in order to prevent national governments from pursuing an overly expansionary fiscal policy – and to sweeten the farewell of the Deutsch-Mark to the Germans. The irony is that it was Germany which was the first[13] to breach the rules of the ESGP in 2002 and has done so ever since. In consequence, the ESPG has been 'softened' only recently[14]. The basic problem with ESGP is that it is based on a very limited understanding of the working of economies in general and budgetary policies in particular and, more important, that this understanding clashes with the understanding underlying the macro-dialogue of the 'Cologne process'[15]; i.e. the architecture of the European economic governance is still self-contradictory and needs further amendment.

Table 3: Policy coordination in the European Union

		Rules or Guidelines	
		Yes	***No***
Sanctions	**Yes**	*ESGP*	*
	No (OMC)	*BEPG* *EPG* *NAP* *Cardiff reports*	*Macro-dialogue*

* sanctions for governance procedures without rules or guidelines seem senseless

5. **The way ahead**

Although it is too early to draw final conclusions on the process of European economic governance, it seems uncontroversial to state that we have seen only the beginning. Large areas of policies have not yet even been integrated into a proper process of economic governance, but it becomes ever more obvious that they need to be integrated: social policies or tax policies for example and wage policies, which are all prone to large negative external effects (see e.g. Scharpf 1997, Genschel 2002, Busch 1998). And even if the sometimes painted picture of gruesome wage and social dumping[16] is

[13] In company with Portugal and France. Only now, ex post, it becomes evident that Greece – a late-comer to EMU in 2001 – has deceived the European Union by conveying incorrect deficit figures since 2000.
[14] Not only deep recessions but also longer periods of economic stagnation are now regarded as situation which may go without sanction, see European Commission, 2004.
[15] While the ESGP is based on the explicit assumption of non-coordination of monetary and fiscal policies, the macro-dialogue's goal is exactly to coordinate these policy areas.
[16] For a critical discussion see Sinn (1999), Boeri (2000), Krueger (2000).

not the most likely scenario to happen[17], a deficient supply of social public goods and a growing shift of the financial burden seems – as argued above – to be unavoidable.

But it is not only the missing policy areas which must be mentioned, but also the governance process itself which needs a second thought: those critics that see a need for coordination but believe a process of 'coordination among equals' to be too unstable or fragile, argue in favour of government at EU-level – a veritable 'European Republic' (see Collignon 2003a, 2003b). The ongoing discussion about a European Constitution which would strengthen the EU level and EU institutions such as the EP and the EC sheds a sceptical light on the viability of this way ahead – at least for the time being. Those critics that also see a need for coordination but do not believe in a 'European Republic' in the nearer future, argue in favour of a different institutional framework in order to strengthen the incentives for cooperation in a political environment where the national perspective is still far more important than the common interests of the EU: the ESGP and the macro-dialogue of the Cologne process need to be revised, the Broad Economic Policy Guidelines and Employment Policy Guidelines must be set into a mode of favouring employment growth and income stability and must be 'hardened' in terms of commitment and credibility.

Table 4: Policy coordination issues in the European Union

		Policy Interdependency	
		Yes	***No***
Common goals	**Yes**	*Macro-dialogue*	*EPG* *NAP* *Cardiff reports*
	No	*ESGP* *Fiscal (tax) policy* *Welfare policies* *Wage policy* *(monetary policy*)*	*National policies according to national preferences*

* supranationalised in the EU

Both positions, relying on strengthened institutions to more effectively coordinate national policies in a European Economic Governance process on the one hand and stressing the need for supranational, hierarchical forms of coordination in terms of a European (Economic) Government on the other hand, are not mutually exclusive, but rather point out that different coordination issues may need different procedures (see tab. 4): wherever coordination is based on a zero-sum game – such as curing externalities of tax and social systems - , the process of concession bargaining in order to establish an efficient governance system may be unpredictable and unviable.[18] Hence,

[17] Different scenarios may evolve, see Heise (2000: 30ff.) or Genschel (2002).

[18] In most cases, zero-sum games occur in direct interactions of economic actors and a market-led coordination (prices as coordination devices) is optimal, if control- and enforcement costs (based on contracts) are low (Dixit has only recently pointed out that this assumption only holds for a few advanced countries and only in recent times. However, economic activity outside theses countries and at other time show that rule- or relation-based modes of self-governance may evolve and remain stable over time; see Dixit 2001). Yet, in our setting, zero-sum games rather take the form of interdependencies which cannot be based on enforceable contracts but

some kind of supranational coordinator would be needed.[19] But wherever coordination starts a positive sum game – as in establishing a truly working macro-dialogue -, a governance process among equals may be both sufficient and efficient.[20]

One thing seems obvious: If the European governance process is not going to work effectively, political (neo-)liberalism intending to cut public goods provision and tax rates in general will prevail and ever more national systems of distribution and social welfare will come under pressure (see e.g. Scharpf 1996). However, this would be no good prospect for further European integration and the establishment of something which is more than a pure 'free trade zone'. Therefore, the process of European economic governance is condemned to work and some kind of supranational European (economic) government must eventually evolve. However, that is still a long way to go.

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would involve complex 'concession bargaining' (see e.g. Reinecke 1998: 73ff.). Such concession bargaining procedures may also end in agreements but are much more dependent on 'systematic incentives' (a hegemon) or complementary pay-off matrices of the actors involved than are self-governed direct interactions.

[19] Therefore, the hopes of the political left bestowed on the OMC as a procedure to safeguard the ‚European social model' if extended to social policy areas, seem to be premature if my analysis is correct (see Rodrigues 2002 and Vandenbroucke 2003, for a more critical view: Radaelli 2003).

[20] However, as the macro-dialogue shows, the governance process needs an appropriate institutional setting (polity) (see Heise 2002 or Watt/Hallwirth 2003).

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