



# **Is Europe going far enough?**

Reflections on the EU's Economic Governance

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#### **Abstract**

*Europe's economic governance is not only highly complex, but also increasingly inefficient and therefore unsustainable in the long run. This conclusion is reached from the theory of collective action and the difficulties in democratic legitimacy. The solution would be the creation of a European government accountable to European citizens.*

The economic governance of the European Union, and especially of the Eurozone, has seen a rapid development since the Maastricht Treaty was signed in 1992 and European Monetary Union (EMU) started in 1999. Governance means the specific ways of deciding and implementing policies through informal rules and formal institutions and a set of agreed objectives. Different institutional arrangements and policy-orientations define different regimes of governance. In this paper I will look at whether the EU's economic arrangements are consistent with its objectives. I will argue that some of them are, others are not and for their efficient governance a central government is required.

The Treaty set the institutional framework for policy coordination through the triad of an independent European Central Bank (art. 105), the Excessive Deficit Procedure (art. 104) and multilateral surveillance through the Broad Economic Policy Guidelines (BEPG) (art. 99). Subsequently a whole range of complementing processes,

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methods and strategies have been introduced, starting with the Stability and Growth Pact (SGP) 1996/97, the European Employment Strategy (Luxemburg Process) 1997, the Cardiff Process 1998 for product and capital market reform, and the Macroeconomic Dialogue (Cologne Process) 1999. Some of these procedures, notably the SGP and the Macroeconomic Dialog focus more on stabilisation policies, the policy mix and demand management, others like the Luxemburg and Cardiff Process emphasise “structural reforms” and the supply side. The Lisbon Strategy in 2000 has also institutionalised the special Spring European Councils and developed the “Open Method of Coordination” (OMC), which was further fine-tuned at the European Councils in Stockholm (2001), Barcelona (2002) and Brussels (2003).

The Lisbon European Council in 2000 designed a comprehensive and integrated strategy for all these separate processes by stipulating to make Europe “the most competitive and dynamic knowledge-based economy in the world, capable of sustaining economic growth with more and better jobs and greater cohesion” (European Council, 2000) The overall strategy was based on four policy areas: (1) Transition to a knowledge-based economy and society by fostering the information society, R&D and innovation, and stepping up structural reform. (2) Completing the single market, especially for financial services in order to facilitate higher investment. (3) Modernising the European social model by investing in people and combating social exclusion. (4) Sustaining favourable economic growth by an appropriate macroeconomic policy mix.

Progress on realizing the Lisbon agenda has been slow. Not surprisingly, the efficiency of Europe’s complex governance has been questioned (Begg, Hodson, Maher, 2003; Calmfors and Corsetti, 2003; Gros and Hobza, 2001, Collignon, 2001) and concern

about the democratic legitimacy of existing policy procedures (“closeness to the EU’s citizens” in the language of the European Council’s Laeken Declaration, 2001) has motivated setting up the European Convention which has now produced the draft of a European Constitution.

With the exception of the European Central Bank and possibly the Convention, all of the recent institutional innovations have strengthened intergovernmental policy coordination; no further policy conferrals to the European level have taken place, while new procedures like the Open Method of Coordination, have been extolled as “reorganising the modes of European construction” (Telò, 2002). This may reflect a general trend toward more intergovernmentalism. Yet, the optimality of this development could be questioned. While economic integration requires institutions endowed with the authority to enact Europe-wide policies, it is often argued that this need may be traded off against costs from imposing identical policies upon heterogeneous groups (Alesina and Wacziarg, 1999; for a critique see Collignon 2003). Therefore subsidiarity is supposed to be welfare increasing.<sup>2</sup>

We need to understand whether the newly developed methods of intergovernmental coordination are appropriate for the tasks they are meant to accomplish. While certainly not all European objectives need to be decided or implemented by a centralised authority, it is also clear that not all forms of intergovernmental policy coordination will have the same effectiveness. There is a role for both intergovernmentalism and the community method. We need to establish criteria which policy regimes are likely to produce best results.

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<sup>2</sup>However, the increasingly prominent role of the European Council and the development of the Open Method of intergovernmental policy Coordination were less a conscious decision for welfare improvement, but rather the second-best option after the failure to adopt common targets and policies. See Rodrigues, 2003.

In this paper, I will look at the different coordination regimes, which are institutionalised in the Open Method of Coordination (OMC), the Broad Economic Policy Guidelines (BEPG) and the Stability and Growth Pact (SGP) and the rules underlying their implementation. I will first discuss the need for policy coordination, and then assess their success in implementation. In conclusion I will draw some lessons for the design of a European Constitution.

## **I. The need for policy coordination**

### *Externalities: the rationale for policy coordination*

The institutional developments in economic policy-making reflect the recognition that “a proper functioning of EMU requires a well-developed coordination framework” (European Commission, 2002:3). This requirement is derived from the fact that although monetary policy is fully unified under the authority of the ECB, most other policy areas maintain separate national policy-making competences. Because policy preferences are defined in national constituencies, different governments have different preferences and objectives. But at the same time the growing interdependence between national economies within the same monetary framework has led to an increasing range of spillovers into other jurisdictions. Many policy variables such as common inflation, interest and exchange rates, but also the aggregate fiscal stance are now produced “jointly” (von Hagen and Mundschenk, 2002). What one member state does, increasingly affects all others and inconsistent policy objectives would lead to welfare lowering outcomes. The internalisation of these externalities creates the need for policy coordination.

Policy coordination is therefore necessary when there are autonomous and non-unified decision-makers - with possibly incompatible (disjunct) preferences and objectives - and when their actions cause spillovers into each other's jurisdictions. Hence, policy coordination is a necessary feature of intergovernmentalism. But besides the argument of interdependence calling for cooperation, we must also consider preference change over time as a crucial element in setting up efficient governance structures. If different actors converge to pursuing the same objectives, other forms of coordination are required than if preferences are disjunct and inflexible. Furthermore, if policy objectives need to be revalued in changed circumstances, discretionary forms of policy-making are more adequate, than if one needs to stick to a given policy rule over time. These considerations determine different regimes of policy coordination, as I will explain in the next section.

Commonly, four arguments are made to explain the need for coordination and these potential benefits apply to both supply and demand side policies: (1) National actions or policies may spill over directly into neighbouring countries. For example, state aids may cause distortions in the single market and must therefore be controlled at the European level. (2) Indirect effects are particularly prevalent for European collective goods. Macroeconomic variables like inflation, interest or exchange rates concern all economic agents in Euroland and if independent national policy actions would cause the ECB to adjust monetary policy, the economic conditions in the whole area would be affected. (3) Coordination should prevent or reduce the likelihood of free-rider behaviour by member-states. (4) Some political economy theories argue that policy coordination may be useful in deflecting criticism of unpopular but necessary policy action at the national level (Drazen, 2000).

Objections to policy coordination have focused on three aspects mainly related to macroeconomic coordination and demand management: (1) The size of spillover effects and potential gains from cooperation may be small (Gros and Hobza, 2001; Curie et al. 1989). For example, the aggregate demand effect of government spending may be compensated by rising interest rates, at least if the economy is close to equilibrium. (2) Policy coordination may cause potential dangers to the independence of the European Central Bank (Alesina et al. 2001; Issing, 2002). (3) A more general objection is that the observed differences in national policy preferences require independent policies to accommodate different “tastes” (Alesina and Wacziarg, 1999). The first two objections are related to the *efficient* policy mix in Euroland, the third is about its *optimality* and is analytically distinct from efficiency considerations. I will return to preference heterogeneity below. Here I will only insist that an efficient policy mix is a necessary condition for the sustainability of macroeconomic stability, but different policy mixes may also set different incentives for economic growth and improvements at the supply-side of the economy. Therefore there are many potential spillovers between different policy domains and coordination between independent actors is one way of achieving consistency between their actions.

However, if coordination fails to produce a coherent set of actions, delegation of decision-making to a central authority may be required. The European governance framework has tackled the issue of coordination from four different perspectives.

(1) Efficient macroeconomic policy is to ensure that the economy achieves non-inflationary, stable growth and high employment (TEU, art. 2). This implies that policy is actually capable of delivering these collective goods. Although this claim is not undisputed, it now seems to command a reasonable consensus

among professional economists (Allsopp and Vines, 2000). In particular, there is agreement that inflation is ultimately always a monetary phenomenon and therefore the central bank needs to be independent to prevail against other actors when there are inflationary shocks. But this independence also requires that monetary policy-making is unambiguously centralised in the European System of Central Banks. The creation of the ECB was an indispensable condition for the consistent design of monetary policy. However, European central bank independence implies a rather unique coordination regime for monetary and fiscal policy.

(2) Even if the central bank is independent, non-cooperative games between monetary and fiscal authorities can lead to destabilising outcomes when the objectives between the two are not consistent (Sargent and Wallace, 1981). Therefore fiscal policy needs to be constrained. This was the economic rationale behind the Stability and Growth Pact. By stipulating precise rules for “avoiding excessive deficits”, the pact reduces the potentially destabilising power of fiscal authorities and frees the ECB to set interest rates compatible with macro economic equilibrium. Whether this always happens is another matter and subject to intensive debate, but this is how the system is supposed to work. Yet, one needs to emphasise that its logic is based on the interaction between the single monetary policy and the European *aggregate* fiscal stance. Under Europe’s present day economic governance, this aggregate is only indirectly defined by the SGP, which stipulates *one budget rule applying to all* - namely “close to balance or in surplus” over the medium term, so that the aggregate structural budget position is also in balance.

(3) Even if all national budgets were in perfect balance, inflationary pressures could still emerge from nominal wage settlements exceeding labour productivity increases. Sustained unit labour cost increases above the ECB inflation target would provoke monetary

tightening with negative spillover effects via interest and exchange rates on economic growth in the short term, but through investment also on capacity and employment in the long run (Collignon, 1999; 2002: chapter 8). The institutional tool for internalising these externalities was the creation of the Macroeconomic Dialogue at the Cologne European Council. Policy coordination under the Cologne Process has been fairly soft, i.e. non-constraining, partly because the ECB refused *ex ante* coordination as a matter of principle, partly because the nature of wage bargaining in Europe is so diversified that uniform procedures are neither applicable nor desirable. The Macroeconomic Dialogue primarily works through the improved flow of information that clarifies the macroeconomic environment for wage bargainers.

(4) An efficient policy mix will keep aggregate supply and demand in balance. But it will also have an effect on the *growth potential* of the EU economy, although the impact may be limited. The transmission mechanism from stabilisation policy to long-term economic growth works essentially through investment in the stock of physical and human capital (Collignon, 2002). Higher growth therefore requires a macroeconomic policy mix that creates an incentive for investment, but this effect would be significantly amplified if structural reform policies created positive externalities in the form of higher productivity. In the context of the European policy framework, the Broad Economic Policy Guidelines (BEPG) are supposed to internalise these reciprocal externalities between macroeconomic management and structural reforms by formulating a coherent document that gives orientation to national policy-makers. The procedures for the coordination of supply-side reforms were already set by the Luxemburg and Cardiff Processes, but only the Lisbon Strategy set out the overall design for achieving these growth and welfare improvements, with the “Open Method of Coordination” (OMC) as its instrument. The OMC is now applied in very different

fields, where general guidelines or objectives at European level are being translated into national action programs (Rodrigues, 2003).

Hence, the EU has both a need for and a wide range of instruments for policy coordination. But how are they used?

### *Governance regimes as forms of coordination*

Welfare increasing policy coordination can be modelled as a game, where the payoff to the players is highest when they coordinate their strategy. The constitutional question is which mechanisms allow independent authorities to consistently Pareto-improve welfare over time. We know from game theory that choice consistency is more easily established in sequential and repetitive games than in games with simultaneous moves,<sup>3</sup> but this advantage comes at the potential cost of dynamic inconsistency with related problems of credibility (Kydland and Prescott, 1977). As we will see, the coordination between monetary and fiscal authorities can easily be set up as a sequential game, but intergovernmental coordination, like the definition of the aggregate fiscal policy stance, can not.

Successful policy coordination has two dimensions: the consistency of objectives between autonomous partners and the dynamics in the interactions over time. If different actors make their decisions simultaneously, they may create positive or negative spillovers or externalities for others, who may anticipate them and respond by taking these decisions into account. If their strategies are mutually consistent, a Nash equilibrium exists, although the outcome is not necessarily Pareto efficient. Policy coordination is then one way of improving the outcome for both. The related compliance problems can be dealt with by setting up specific incentive structures (positive rewards, negative sanctions and institutions as commitment devices)

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<sup>3</sup> For a good introductory overview, see Varian, 2003.

or by convincing others of the “rightness” of a proposed action.<sup>4</sup> In the first case preferences remain given and fixed, and feasible outcomes are the result of strategic bargaining and side-payments. In the second case, the policy preferences actually change due to public deliberation. The relative importance given to incentives and persuasion distinguishes hard from soft coordination regimes. The flexibility by which policy objectives can be changed determines the degree of discretion versus rule-governed policy actions.

When decision-making is sequential, *ex ante* coordination is not necessary and can be replaced by *implicit* coordination. Actions are then coordinated between a leader and follower. A typical case is the interaction of fiscal and monetary policy in EMU. The ECB interprets its status of independence as incompatible with *ex ante* coordination. Indeed, if a previous commitment to coordinated policy action would constrain the ECB’s capacity to react in case of any inflationary shock, it may lose *de facto* independence and the credibility of its commitment to maintain price stability. But this does not necessarily prevent the central bank from setting interest rates at a level that is consistent with macroeconomic equilibrium. In contrast to the Sargent and Wallace (1981) framework of a ‘chicken game’, interactions between European fiscal and monetary policy should be modelled as a sequential game, where the ECB is the Stackelberg follower (Allsopp and Artis, 2003: 14). The sum of national budget positions first determines the aggregate fiscal stance in Euroland; while the ECB preserves the freedom to decide which monetary policy stance is compatible with it. The potential handicaps of this institutional set-up are limited by the *ex ante* constraint of the SGP on national budget positions and by the

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<sup>4</sup> In game-theoretic terms, this means changing the payoff-matrix for specified actions.

commitment of the ECB to a conservative attitude on fiscal policy.<sup>5</sup> The sequential model of fiscal and monetary policy coordination therefore reduces the inflationary dangers of “unpleasant monetary arithmetic” without jeopardizing the possibility of an efficient policy mix. Hence, monetary and fiscal policy in EMU is only indirectly and sequentially coordinated, i.e. *ex post*, and not simultaneously or *ex ante*.<sup>6</sup> The ECB is apparently operating with such sequential model in mind:

“...there are no convincing arguments in favour of attempts to co-ordinate macroeconomic policies *ex ante* in order to achieve an overall policy mix favourable to growth and employment. On the contrary, attempts that extend beyond the informal exchange of views and information give rise to the risk of confusing the specific roles, mandates and responsibilities of the policies in question. They thereby reduce the transparency of the overall economic policy framework for the general public, and tend to prevent the individual policy makers from being held accountable. (...) Obviously, if national governments and social partners take the single monetary policy’s credible commitment to maintain price stability as given, when deciding on their actions, this will lead to *implicitly* coordinated policy outcomes *ex post*, while at the same time limiting policy conflicts and overall economic uncertainty.” Issing (2002)

Coordinating monetary and fiscal authorities is one thing, policy coordination *between European governments* is quite a different one. Here *sequential or implicit coordination is not possible* because the strategic interactions may resemble the prisoner’s dilemma. In this case policy coordination by contracting and punishment for defaulting would improve the policy outcome. For example, the aggregate fiscal stance is determined by all member states simultaneously. National governments retain responsibility for national budgetary and structural policies with high potential for

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<sup>5</sup> This conservative line of insisting on the need for fiscal consolidation is frequently re-iterated in ECB publications, but also in the confidential discussions in the Eurogroup, as the author could witness in 1999.

<sup>6</sup> The same argument can be made for the implicit “coordination” between monetary and wage policies.

spillovers, but they are exclusively accountable to their domestic constituencies. Hence, there is no European institution able to provide “implicit” leadership to others. But if fiscal rectitude is politically costly at home, although Pareto-optimal for the Union, a dominant strategy would be to behave with fiscal laxity. Hence the need to establish coordination rules in the form of the Stability and Growth Pact. This is probably the most prominent coordination problem in Europe today, but the argument also applies to a much wider range of policies.

Traditionally, the European Union has used four methods to deal with the externalities caused by simultaneous decision-making of autonomous governments.

(1) *Voluntary coordination* between member states. If governments can agree in advance on what they want, policies are *ex ante* coordinated through consensus. There is then no risk of default, because each individual government does exactly what they all want to be done collectively. Hence voluntary coordination requires at least preference coherence, if not preference convergence between different actors. Specific coordination processes serve to facilitate the emergence of a consistent policy consensus. The Macroeconomic Dialogue under the Cologne process and the Open Method of Coordination are forms of voluntary coordination where public deliberation, the exchange of information, and peer pressure through naming and shaming are to facilitate policy preference convergence. The subsequent voluntary commitment to common objectives would eliminate negative externalities and create welfare effects from policy coordination. However, this form of coordination only applies to discretionary policy making, as voluntary agreements are made case by case, issue by issue and each partner retains the full sovereignty to join or withdraw from the process. Begg, Hodson and Maher (2003) call this the “loose mode of coordination in the EU.”

(2) *Binding rules* are necessary when the short-term preferences of different actors are inconsistent with their long-term preferences. Simple voluntary adherence to coordinated policy action is not enough to ensure compliance over time, as the actors are autonomous and free to withdraw from the agreement in the future. By making a binding commitment to an agreed long-term goal, dynamic consistency between multiple policy plans can be established. However, this poses another problem: will different autonomous actors honour their commitment to the policy rule over time? If the preferences of different actors are disjunct and do not converge over time, non-compliance is highly likely and a regime of hard sanctions is required in order to deter deviating behaviour. The regime of sanctions changes the pay-off matrix and therefore the incentives for strategic behaviour. Hard policy sanctions provide pigouvian distorting incentives. The typical example is the Excessive Deficit Procedure, which has been further ‘hardened’ by the sanctions envisaged by the Stability and Growth Pact. Explicit Treaty provisions establish the coercive mechanisms as legally binding obligations. I will return to the question of legality below.

(3) Between hard and loose modes of coordination stands the intermediary regime of soft rules. Begg, Hodson and Maher (2003) refer to this regime as the “guided” coordination of the BEPG and the Luxemburg Process. If the policy preferences between actors converge, they are more likely to act in a similar and consistent fashion given a specific set of circumstances. A policy rule is then necessary to prevent dynamic inconsistencies, but non-compliance by individual actors is less an issue and therefore requires only a “soft” sanction regime.<sup>7</sup> Soft coercive mechanisms, such as “naming and shaming”, are not legally binding, although the exchange of information, collective learning and peer pressure do contribute to

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<sup>7</sup> Of course, the problem of collective compliance to the rule and the temptation of dynamic inconsistencies for the coordinated policy still persist.

the convergence of preferences. Agreed policy documents, like the BEPG or the National Action Plans for Employment, formulate rules as guidelines or focal points for medium term policies, while the implementation of policies is revalued on an annual basis, allowing a certain degree of discretion in policy making.

(4) Finally, the *community method of delegation*, now called ‘conferral’ in the new constitution draft, transfers policy-making competencies to a unified agent such as to the European Commission or the European Central Bank. In this case, policy decisions are no longer made by autonomous actors with responsibilities to different constituencies and a need for *ex ante* coordination. Instead the unified authority formulates and implements policies with respect to an enlarged constituency, internalising all externalities by *legally obliging* other actors or governments. Delegation is the appropriate policy regime when national policy preferences are disjunct and discretionary decisions need to be taken, for otherwise anarchy and conflict dominate and prevent welfare improvement.

We can summarise these different policy regimes in Figure 1. The two dimensions are *preference consistency between actors* and *time consistency between actions*. Disjunct preferences require “hard” regimes of legally binding policy decisions in order to internalise the spillovers of externalities. If dynamic consistency can be achieved by formulating a general obligatory policy rule, then coordination of autonomous actors is possible, provided they stick to the rules. If, however, policy decisions need to be revalued frequently and actors have disjunct preferences, they may be better off in delegating policy-making to a centralised authority acting as the agent of a larger constituency. Both regimes pose questions of democratic legitimacy, discussed below. On the other hand, if heterogeneous preferences converge to a generally accepted policy consensus, due to public deliberation, mutual persuasion and learning, then the

simple exchange of information and less constraining forms of policy coordination may be sufficient to improve welfare. Voluntary cooperation would be appropriate for specific discretionary issues, while a soft and flexible framework of policy rules would allow the integration of voluntary cooperation into dynamically consistent policy programs.

**Figure 1. Policy Coordination Regimes**

		Time consistency	
		Discretionary policies	Rule-based policies
Preference consistency	disjunct	I. <u>Delegation to unified actor</u>  Commission, ECB	II. <u>Hard coordination with sanctions</u>  Stability and Growth Pact, Excessive Deficit Procedure
	converging	III. <u>Voluntary coordination</u>  Open Method of Coordination, Lisbon Strategy	IV. <u>Soft coordination by guiding rules</u>  BEPG, Luxemburg and Cardiff Process

The evolution of these governance regimes seems to follow a trial-and-error path. When neo-functional federalists encountered resistance, they moved to softer forms of coordination, which opened the way for hard coordination again. I will now ask whether we can find an underlying logic to these regime choices.

*Collective goods: linking externalities and coordination regimes*

We may interpret the outcome of policy decisions as collective goods. The appropriateness of a governance regime may then be measured by the regime's effectiveness to produce these collective goods. However, as the theory of collective action was shown, this effectiveness depends largely on the nature of collective goods.

The classical definition of public goods is that (1) once produced they are available in the same amount to all the affected consumers (jointness of supply) and (2) that everyone must consume the same amount of the good, i.e. the supply of the good cannot be restricted to those who produced it (non-rivalness for consumption). However, as Figure 2 shows, the concept of collective goods is larger. If only condition (1) holds but not (2), the collective good is called a club good; in the opposite case it is a common property resource.

Collective goods, characterised by different externalities, require different forms of governance. However, the link is not a simple transposition from figure 2 to figure 1. The crucial distinction lies in the nature of expectations formed by autonomous actors regarding their pay-offs and the implications for interactive equilibria.

**Figure 2. Typology of Collective Goods**

		Consumption (Benefits)	
		Excludable/rival	Non-Excludable/non-rival
Supply (Cost)	Non-joint/rival	I. <u>Pure private goods</u> (exclusive goods) Apples, pears.	II. <u>Common property resources</u> (exclusive collective goods) Oil wells, fisheries,
	Joint/non-rival	III. <u>Club goods</u> (inclusive goods) Swimming pool, EMU	IV. <u>Pure public goods</u> (non-exclusive goods) Defence, lighthouses,

Olson (1971) has shown that the club goods in box III of figure 2 are inclusive goods in the sense that (below a given capacity limit) an existing club may increase the total benefit from membership by admitting new members. For example, the value of membership in my Tennis club may increase when I can draw on a larger pool of potential partners to play with. In this case the benefits of individual

members are complementary to each other. The recent literature on network externalities has also observed the positive correlation between benefits and the number of group members. As Katz and Shapiro (1985) formulate: “There are many products for which the utility that a user derives from consumption of the good increases with the number of other agents consuming the good.” They defined the concept of network externality as: “[T]he utility that a given user derives from a good depends upon the number of other users who are in the same network”.

The interactions between agents determine the level of payoffs and can therefore be related to collective goods. Cooper and John (1988) have provided a general framework that goes one step further to the level of actors’ strategies.<sup>8</sup> They show that strategic complementarities arise if an increase in one player’s strategy increases the optimal strategy of the other players. This can lead to multiple symmetric Nash equilibria, where mutual gains from a possible change in strategy may not be realised, because no individual player has an incentive to deviate from the initial equilibrium. Thus, strategic complementarities would prevent an optimal allocation of inclusive collective goods, unless a mechanism is in place to ensure that coordination failure is overcome. It can be shown that inefficiencies due to strategic complementarities can be Pareto-improved by ensuring that all agents have equal access to information allowing them to deviate from an initially sub-optimal equilibrium and reap the full benefits offered by network externalities (see Benassi et al. 1994).

These models are useful for our understanding of policy coordination. In fact, the positive spillover of a given common policy on any individual jurisdiction would only take place, if all

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<sup>8</sup> Technically, spillover models look at the first derivative of a collective utility function, strategic cooperation failure models focus on the second cross derivative.

individual governments were convinced that their marginal contribution to the common policy has a positive effect on their own constituency,<sup>9</sup> otherwise they will abstain. In this case collective preferences between autonomous actors will converge, and this is exactly what the soft policy coordination regimes in box III and IV of Figure 1 are supposed to achieve: increased flow of information, exchange of best practices, peer pressure are all mechanisms to “tip” a policy network away from an initial sub-optimal equilibrium and moving it to a higher Pareto-dominated equilibrium.<sup>10</sup> This logic has two implications: (1) Due to *strategic complementarities*, voluntary policy coordination and adherence to guiding rules will be forthcoming if, and only if, a soft institutional structure ensures the “tipping” of the preference convergence. (2) The group of decision-makers can be large, as network externalities increase strategic complementarities. Hence voluntary and soft policy coordination is the appropriate regime for the provision of inclusive collective goods. Enlarging the EU may increase the overall utility of European integration for all members.

However, the case is different for exclusive collective goods, i.e. common resource goods (box III in Figure 2). Policy coordination for exclusive collective goods is hampered by *strategic substitutabilities*, which can be caused by two different forms of externalities. (1) Although consumption of inclusive collective goods is the same for all group members, their access (supply) is rival, meaning that the share of benefits for each group member falls as the number of participants increases.<sup>11</sup> As a consequence, the feedback to the expectations of existing group members is negative. This creates strategic substitutabilities i.e. the second cross derivative of the utility function is negative. The individual marginal benefit for a new or deviating member of the group is positive, but for existing or

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<sup>9</sup> For the formal deduction of this argument refer to Cooper and John, 1988.

<sup>10</sup> On “tipping” see Katz and Shapiro, 1994

<sup>11</sup> For a formal deduction of this statement see Collignon, 2003, annexe 2.

conforming members it is negative. Thus, there exists an incentive to go against the collective interest (such as the SGP) insofar as existing members' willingness to pay for collective goods will be reduced as the number of group members increases. Large groups will therefore become "latent" in Olson's (1971) terminology, i.e. the *likelihood of a large group providing an exclusive collective good voluntarily will diminish*. Thus, EU-enlargement is likely to destroy the benefits from European integration for exclusive collective goods, if left to voluntary policy coordination between member states. (2) Because benefits are the same for all group members, but access is rival, it is possible to externalise production costs to others and *free-ride*. For example, uncoordinated borrowing in the financial markets by any public authority could cause externalities with respect to interest and exchange rates or inflation that would affect all other authorities within the same currency area. However, the free-rider benefits from low interest rates are "produced" by other member-states' collective fiscal restraint and this creates a generalized incentive for non-compliance with the policy rule. Therefore hard forms of policy coordination or even, as in the case of monetary policy, *delegation* to a European authority are required in order to provide these collective goods efficiently. The argument applies with force to the determination of aggregate fiscal policy as an instrument of stabilisation, because implicit coordination is impossible, but also to a range of other policy coordination issues, including a common foreign and security policy.

The two points can interact. The zero-sum game quality attached to common resource goods provides an incentive to keep the group of collective decision-makers small, for otherwise one risks the non-provision of the collective good.<sup>12</sup> But if the group is enlarged, the provision of collective goods will be reduced and ultimately cease.

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<sup>12</sup> Olson 1971:28 argued that large groups have a tendency to provide themselves with no collective goods at all, whereas small groups tended towards a sub-optimal provision of collective goods.

Hence, intergovernmental voluntary policy coordination will not be sufficient to provide large groups of countries with an efficient or even optimal amount of collective goods.<sup>13</sup> A consistent approach to policy coordination for such goods requires “hard” regimes of governance. Thus, the boxes I and II in Figure 1 are governance regimes necessary for the provision of exclusive collective goods. However, it is also clear that the regime described in box II, where governments keep their autonomy, will become increasingly less effective as the European Union enlarges to new members. Strategic substitutabilities will undermine adherence to and compliance with the rules however “hard” they may be. This is the “collective action problem” of European integration. It implies that governments cannot be the ultimate source of European political legitimacy. Because the problem becomes more acute after enlargement, a profound rethink of Europe’s economic governance in a Union of 25 or more member-states is unavoidable unless half a century of integration is to be undone.

## **II. Policy Coordination and Legitimacy**

How well is the EU’s economic governance working? Its efficiency is not independent of the consistency of policy preferences and choices. If these do not fit together and contradict each other, policy outcomes will be suboptimal. We would expect that soft coordination regimes may be enough to supply inclusive collective goods efficiently, because these goods provide incentives for consistency. With exclusive goods this is not necessarily the case. I will now argue that even hard coordination regimes are no guarantee for their optimal provision. More integration by conferral is then the efficient response, but this poses problems of legitimacy.

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<sup>13</sup> In Collignon 2003:113, I have discussed the welfare-enhancing role of the Franco-German axis for European integration in this context.

Legitimacy indicates that policy choices have been made in accordance with the society's generally accepted procedures and values. It means that legitimate decisions do not violate the society's core system of values and they are consistent with the underlying set of beliefs, attitudes and expectations. When policies are considered legitimate, they can be efficient in terms of allocating scarce resources to the realisation of their aims. The policy output may then reinforce their legitimacy ('output legitimacy'). However, the inverse is not always true: policies can be efficient and lack legitimacy when policy objectives are inconsistent with underlying sets of beliefs. As a consequence, the efficiency of policy decisions is not sufficient to legitimise them. In a non-dictatorial society lack of legitimacy may lead to suboptimal policy equilibria as decision makers will not find the necessary support to carry their policies through.

Figure 1 showed inconsistencies, which can arise over time or across policy constituencies. Hard coordination rules aim to eliminate time-inconsistency, whereby policy-makers may be tempted to exploit opportunities that arise from breaking previously made commitments. Related to this, but much less discussed are issues of legitimacy arising from collective preference change. This is a problem of *reverse time inconsistency*, when established rules prevent making new agreements in accordance with changed beliefs and expectations. Hence legitimacy may suffer from an established rule, if the set of underlying values has changed with respect to the general consensus at the time when the rule was agreed. Secondly, policy inconsistencies may arise from 'fractured' or insufficiently integrated constituencies. Contradictory value sets prevent then the formulation of generally accepted collective choices.<sup>14</sup> By protecting

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<sup>14</sup> To prevent misunderstandings: I am not claiming that collective decisions must be taken unanimously or that disagreement about choices does not exist. But in democratic societies there is acceptance of public choices due to the shared commitment to democratic, liberal and procedural values.

and encouraging the free communication between citizens and by open competition for policy ideas and party programs, democracies contribute to a reasonably rapid convergence of underlying beliefs about collective preferences, values and choices (see Collignon 2003 for a formal model). The problem with European policy making is that by confining policy deliberation to national public spheres, the underlying sets of beliefs remain persistently inconsistent. The resulting crisis of legitimacy contributes to inefficient policy choices.

### *The efficiency of EU governance*

In recent years, policy processes have focussed on providing *inclusive collective goods* by intergovernmental forms of coordination. This is particularly evident for a wide range of objectives defined by the Lisbon Strategy that display quasi-network externalities. Examples are policies for the Information Society, such as the deregulation of telecommunications, cyber space, digital TV, or creating a single sky, where a lapse of number of participating users increases utility. These network goods also have spillover effects on other sectors like human resources, agreeing on a Community patent or integrating a Europe-wide financial market (European Council, 2003). By following the benchmarks set out by the coordination process, member states increase their competitive advantages. Hence, there are strategic complementarities between their actions and it is not surprising that European integration has progressed in these policy areas in recent years, as Rodrigues (2003) shows.

However, these successes apply mainly to inclusive public goods with network externalities. For inclusive goods outside networks, progress is much slower. For example, the liberalisation of energy markets, implementing the Lamfalussy report on capital market

integration, or research policies aimed at increasing R&D in the private sector have been tedious, to say the least. It could be argued that the monopolistic provision of national utilities, like electricity, is better classified as an exclusive collective good (a common property resource) than as a network externality. Little progress has been achieved on social cohesion, pension reform or a European framework for social protection that would facilitate cross-border labour mobility. In most of these cases we witness hardly any convergence of national policy preferences. National governments protect particular interests relevant to their national constituencies and this prevents not only convergence, but often even the implementation of previous agreements.<sup>15</sup>

While soft coordination seems to work on balance for inclusive goods, the policy regime of hard coordination is facing serious difficulties, not only with efficiency, but also with legitimacy. There is now a wide range of public policies in the EU creating *exclusive collective goods*, which require harder forms of coordination.<sup>16</sup> The most prominent example is the Stability and Growth Pact. The creation of European Monetary Union has significantly extended the range of these goods. I will therefore focus on macroeconomic stabilisation policies as the paradigmatic case.

### *Consistency and legitimacy*

As the theory of fiscal federalism has shown (Oates, 1972), macroeconomic stabilisation policy is an important subset of exclusive collective goods. The experience with the Stability and Growth Pact has also revealed that stabilisation policies are dominated by strategic substitutabilities in the context of

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<sup>15</sup> The Commission has more than 1,500 legal actions pending against member states for breaches of EU legislation (Financial Times, 23.04.03).

<sup>16</sup> For a tentative list of policy assignments to the inclusive/exclusive distinction, see Collignon 2003.

discretionary policies. This fact reflects well-known problems of dynamic consistency inherent in fiscal policy. By setting hard coordination rules for fiscal policy with the common objective to balance structural deficits in every member state, the SGP addresses this problem. However, there are two difficulties.

First, are we really sure that fiscal policy should be rule-based and not discretionary? At least from a Keynesian point of view, fiscal policy must be 'flexible' to counter insufficient demand in the business cycle and some argue that hard coordination rules inhibit this. Yet, it is not clear that the SGP prevents fiscal flexibility. The Commission has frequently argued that with balanced structural budgets, there is plenty of room for cyclical deficit variations. Furthermore, automatic stabilizers did work in the recent slowdown, although they were not the principal cause for breaking the 3 percent deficit targets. Instead, there was a clear lack of commitment to balance structural deficits in several countries in the early boom times of the EMU. Pro-cyclical tax cuts reinforced the difficulties of keeping to the deficit limit. The 'sinning countries', Portugal, Germany, and France are those who made the least adjustments in good years and are now calling for more discretion in fiscal policy. However, the whole point of the Pact was to prevent this kind of discretion. The theory of collective action tells us that if one were to increase 'flexibility' in *national* budget positions, the most likely outcome would be more volatile monetary policy with less, rather than more macroeconomic stability. For more discretion in national budgets would create an uncoordinated aggregate stance. The ECB, acting as a Stackelberg-follower would have to adjust interest rates more often and this creates instability in financial markets with negative consequences for output. Hence, what is needed is *flexibility in the coordinated aggregate rather than the national budget position*. The question then arises how rule-based coordination between autonomous fiscal authorities can provide

policy discretion at the European level. Because stabilisation policy is an exclusive good, collective action problems are likely to prevent this outcome. Therefore, the determination of the aggregate fiscal stance should be delegated to the European level. But this raises the issue of the democratic legitimacy of policy decisions in heterogeneous constituencies.

Most analytic models assume policy preferences as *ex ante* given and derive government actions from utility maximizing behaviour. It does not matter for our discussion whether this utility is national welfare or narrow interest by politicians. The point is that given the autonomy of national budget policies and the preponderate role of national Parliaments, national policy preferences are disjunct and exogenous to the European level. Under multilevel governance, governments then bargain for solutions, which make the distribution of costs and benefits acceptable *for them* or for the specific constituency they represent. At the EU-level, heterogeneous policy preferences are made consistent. However, neither the outcome of the bargain, nor the bargaining process itself, is supposed to change *ex ante* preferences within the national framework. Therefore the underlying preferences remain inconsistent. The bargained solution is ‘sold’ as the best possible result given the constraints, or as a ‘minimised loss’. But for ordinary citizens, a loss is a loss, whether minimized or not. Because there is no political competition at the European level for alternative policy solutions, none is accountable for the optimality of *European* policy decisions, and governments do not have to convince voters that a policy decision is optimal with respect to the provision of European collective goods.<sup>17</sup> Thus, the EU does not have mechanisms to facilitate European-wide preference change and the emergence of a consistent system of values and underlying beliefs – a process that usually takes place

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<sup>17</sup> In fact, it is exactly this logic that allows abuse of “Europe” for the “politics of blame”.

within member states through the collective deliberation of parliaments, citizens and voters. As a consequence, European policies suffer from a “democratic deficit” in the sense that citizens feel disenfranchised from policy decisions negotiated between governments and their bureaucracies.

The coordination problem is reinforced by democratic preference change *within* national constituencies that I have called ‘reverse time-inconsistency’. For example in recent years, a significant shift from left to right wing governments has taken place in Europe, reflecting the obvious fact that policy preferences within different constituencies are not cast in stone. Some of the recently elected governments have expressed fiscal policy preferences different from what the Stability Growth Pact demands, and therefore, they see the SGP as an obstacle to the policies for which they have been elected<sup>18</sup>. Yet, the purpose of the Pact was exactly this: to prevent discretionary changes in fiscal policy (see Figure 1). But then the question arises: why have elections in the first place, if nothing can be changed? We are touching here the core of democracy.

*The fatal flaw: Lack of democracy*

All theories of democracy presume that people who live together in a society need a process for arriving at binding decisions that take everybody’s interests into account. One common justification for democracy allies the premises that people are generally the best judge of their own interests with the argument that equal citizenship rights are necessary to protect those interests (Gutmann, 1993). The first premise refers to citizens’ equal distribution in collective judgement and emphasizes *communication*. The second relates to the equal contribution of the *power* to make collective decisions (Warren, 2001). However, the frame of reference is the range of

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<sup>18</sup> Coeure and Pisani-Ferry, 2003, discuss some reform proposals.

collective goods, as that is what affects citizens' interests. Different public goods may affect different groups of citizens, as shown by the theory of fiscal federalism. I am here concerned with collective European goods i.e. policy outcomes which affect all citizens of the European Union or at least Euroland. The democratic deficit will then arise at the European level if either citizens are not participating equally in the deliberation of European policies, or if their power to make decisions is unequally distributed. Both are the case in the EU. In fact, communication and deliberation on European policies is primarily concentrated in national constituencies and on national political competition, because this is the only institutional vehicle through which citizens can participate in policy making. But the consequence of this fact is that political preferences for European collective goods converge to disjunct national preferences rather than to European preferences. Furthermore, the distribution of power to make decisions is truly asymmetric, as the ultimate power is with the Council over which European citizens have no equal rights. This is not only an argument about voting rights,<sup>19</sup> but also about the impossibility to remove European decision-makers collectively.

National governments are accountable to their national constituencies. If these constituencies have national rather than European preferences, democratic choice through national elections will ultimately have primacy over negotiated intergovernmental cooperation and coordination-failure is looming large.<sup>20</sup> The simple conferral of budget policy to the EU-level without addressing the democracy issue is therefore problematic. The Maastricht Treaty has

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<sup>19</sup> For a comparison of inequality in voting rights between Council and the European Parliament see Collignon, 2003.

<sup>20</sup> The French Prime Minister J.P. Raffarin made the point in a television interview on 4 September 2003: "My prime task is not to make equations add up and do problems of arithmetic so that this or that office in this or that country is satisfied. My task is to make sure there are jobs for French men and women". And the leader of the government party UMP, A. Juppé seconded: « *Nous sommes élus par des français, il vaut mieux que ce soit des Français qui soient contents de nous* ». ([www.democratie-socialisme.org/article.php3?id\\_article=145](http://www.democratie-socialisme.org/article.php3?id_article=145))

left responsibility for fiscal policy at the national level, presumably because this form of subsidiarity represented greater democratic legitimacy. It has thereby also confined deliberation of what is best to a level where not the *interest of all* affected European citizens are taken into account, but only those of partial constituencies. On the other hand, the hard coordination rule in the SGP, if followed, makes budget choices consistent at the European level. Thus, there is a potential contradiction that must lead to the de-legitimisation of European policies.

This model can be contrasted with the experience of the United States. In the 1980's, under the Reagan/Volker policy mix, government deficits and interest rates were high, whereas under the Clinton-Greenspan policy mix in the 1990's, deficits and interest rates were low. Whatever the historic causes and explanations, these two different policy mixes indicated varying democratic priorities for economic policies,<sup>21</sup> which were fully debated during the Presidential campaign in 1992. Hence policy choices reflected voter input as democratic theory stipulates. In the EU, however, the policy preference for balanced budgets in the Stability and Growth Pact is written in stone and preference changes in some countries are superseded by the hard coordination rule. Yet, the choice of an efficient policy mix among a variety of consistent combinations of monetary and aggregate fiscal policy must be made at the EU-level. An optimal policy mix should maximise European citizens' preferences, not those of governments.<sup>22</sup> The democratic principle applied to the Community method of competence delegation to the EU-level would require a European constituency.

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<sup>21</sup> See Collignon, 2003: chapter 6 for a fuller discussion.

<sup>22</sup> This argument does not ignore the fact that the fiscal stance is usually the outcome of aggregating preferences for distributive fiscal measures on the income and expenditure side of the budget. But I believe that voters also judge the coherence of distributive measures proposed by competing parties.

*The Constitutional Challenge.*

If the European Union wants to sustain and improve its legitimacy as a policy-maker and ultimately its power, it must function as a democratic society. Hence, it will need a mechanism to formulate policy preferences by European citizens at the European level. This is less a problem for inclusive collective goods, where strategic complementarities provide the incentive for endogenous preference convergence and where the Open Method of Coordination between governments will yield results. But when exclusive collective goods demand at least some degree of discretion of policy-making, not only is delegation to the EU-level necessary, but also the accountability of European policy makers to a singly European constituency, for otherwise neither collective judgement nor power will be equally distributed between citizens.

For example, as an exclusive collective good, the definition of the *aggregate* fiscal policy stance is a collective European good in Euroland, as it may affect inflation, interest and exchange rates. It needs to be delegated to the European level, for only there can it be determined coherently as the complement for monetary policy. However the definition of the aggregate deficit lacks democratic legitimacy, unless it commands the consent of the majority of European citizens. Of course, the collectively preferred fiscal stance is largely the outcome of the policy debate on distributive outcomes; the majority of citizens may not even understand the definition of an aggregate stance (what is in, what is out etc.). However, consistency requires that all the distributive arguments are taken into account when formulating collective preferences. Yet, when collective deliberation, communication and judgement only takes place in national constituencies, the emerging consistency of preferences is national and not European. The binding force of the democratic

process for collective decision-making does then not extend to the provision of European public goods.

The formation of collective preferences across Europe requires the democratic competition between rival elites for rival policy agendas and the involvement of ordinary citizens in European-wide policy deliberation (see also Hix, 2003). Clearly the control of the EU policy agenda by national governments with their bureaucratic infrastructure does not allow democratic competition. What is at issue here is the nature of political cleavages: Should European policy-making be dominated by national-cultural-communication cleavages or by cleavages of interest and political choice? By focusing on intergovernmental forms of governance, the dominant cleavage in Europe is national and this fact re-enforces the power and influence of dominant political forces in each member state at the expense of minorities. The EU's governance reflects therefore a 'cumulative cleavage'. Alternatively, establishing democratic structures for collective choice at the European level will cross-cut traditional cultural cleavages and reduce their impact. This would not only support European integration by encouraging trans-border political alliances *below* government level, but it may actually be necessary for its survival: we know from other cases that cumulative cleavages may create a crisis of legitimacy that could lead to the collapse of the system (Dunleavy and O'Leary, 1987).

The active involvement of citizens in EU-wide policy deliberation will happen if and only if they become voters that can censure a European government and this government will be accountable to its citizens. Today this is not the case in the European Union. European policies are largely defined through deliberation in the Council, but governments' accountability is to national and not European constituencies. Political competition takes place within member states, not within Europe. As a consequence, national interests

dominate collective European interests; the universal is dominated by the particular. The ‘common concern’ is substituted by the concern of national governments to get re-elected and of national bureaucrats to keep their competences. Therefore what is needed is not just a *gouvernement économique*, but effectively a Government of Europe. This is not a statement of faith, but simply the conclusion from the logic of collective action. This logic gives us compelling reasons why exclusive collective goods are unlikely to be supplied optimally by large groups of countries on a voluntary basis. Conferral of decision-making to a higher, European authority is necessary to improve welfare. A European Government, naturally evolving from the European Commission, must reflect European-wide policy preferences, but it would also contribute to their emergence through being elected by and accountable to European citizens<sup>23</sup> or their representatives in the European Parliament. In practical terms this means that all economic policy competences for exclusive goods, such as stabilisation policy, must become a matter of co-decision with the European Parliament, rather than being monopolised by the Council.<sup>24</sup>

It is often argued that fiscal policy-making should remain at the national level because national policy preferences are heterogeneous and centralisation creates preference frustration and other inefficiencies (see for example Alesina and Wacziarg, 1999). However, this argument for subsidiarity is wrong. If a European government is liable to its citizens, the political process of electing such a government creates structures of policy competition. European-wide deliberation in the form of electoral contest will then reduce preference heterogeneity and policy dissent, because the competition for individual votes by parties and candidates requires

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<sup>23</sup> For the role of the private sector and engaged citizens in European-wide policy preference formation, see Collignon and Schwarzer, 2003.

<sup>24</sup> This applies in particular to the TEU articles 99, 100, 102, 103(§2), 104 (§ 6, 7, 10, 14), 107 (§6), 111.

them to explain their policies and engage the electorate, but also because they need to build political alliances across borders to gain power. Before choosing, voters seek information. New information will change old preferences. Thus an integrated polity across Europe would emerge *as a result* of establishing a European government. By contrast, if policy choices are made by national governments, who are only accountable to national constituencies, policy preferences will naturally diverge and remain disjunct, given that national policy debates reflect essentially the national constituency. Therefore the degree of dissent, preference heterogeneity and policy frustration is structurally higher if policy-making remains in the exclusive domain of national governments.<sup>25</sup>

The implications for policy-making in general and for EMU-stabilisation policies in particular are important. The weakness of the Stability and Growth Pact is less its short-term inflexibility, i.e. the degree of binding obligation, but rather its lack of democratic legitimacy in the long term. Although hard budget constraints for fiscal authorities are a necessary condition for macroeconomic stability, such institutional rules are only sustainable if they are backed by collective acceptance. The purely procedural argument that the SGP has been ratified by democratic governments is not a sufficient guarantee for its success or long-term legitimacy. What is necessary is to define the macro-economic policy stance at the European level that coordinates implicitly the unified monetary policy with the aggregate fiscal policy stance and reflects the democratic policy preferences of all citizens. (For practical implications see Amato 2002, Collignon 2003).

## Conclusion

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<sup>25</sup> I have given formal models for this argument in Collignon, 2001 and 2003.

Europe's economic governance seems not only to be highly complex and of doubtful efficiency, but it is also unlikely to be sustainable in the long run. The Open Method of Coordination as created under the Lisbon Strategy is not the solution for the optimal provision of collective policy goods that is required to make Europe 'one of the most competitive economies' in the world. The reason is that this method is only able to achieve results in the domain of inclusive collective goods that create strategic complementarities and common synergies. But as a result of setting up EMU there is a large new class of collective goods, which cannot be efficiently provided by voluntary cooperation between national governments alone. They require not only policy coordination through hard rules to constrain deviating behaviour, but also full democratic legitimacy for their implementation. Today's policy regime, dominated by an increasing number of intergovernmental policy arrangements resembles the pre-democratic *Ancien Régime*. Unless it deals with its democratic deficit, the EU runs the risk of being thrown into the dustbin of History by a revolution, which would have little to do with the noble principles that inspired Jean Monnet and European integration ever since. The solution is endowing the European Union with a truly democratic constitution, putting European citizens at the centre rather than governmental bureaucrats. Anything else risks the disintegration of Europe, given the increasing difficulties of voluntary policy coordination in an enlarged European Union. The conflicts around the Common Foreign and Security Policy regarding the war on Iraq are early warning signs of difficult times ahead.

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