# Introduction

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The European Council adopted bold strategic objectives for the economy of the European Union at its summit meeting in Lisbon in 2000. The Council aimed to achieve nothing less than the world's most innovative and dynamic knowledge-based economy within a decade, that is to say by 2010.

The adoption of clear and ambitious objectives made sense to the extent that it gave focus and direction to EU policy-making. Moreover, the authors of the Lisbon agenda were acting on the assumption – appropriate under the circumstances – that the achievement of a dynamic economy was a precondition for the successful carrying-out of the sweeping political transformation of the Union then underway.

This transformation includes the enlargement of the Union from fifteen to up to twenty-seven countries, and the political and institutional reorganization of the Union, including a new constitution that will modify the original founding treaties. This will take place through an intergovernmental conference on the basis of the preparatory work being done by the European Convention on the Future of Europe.

As such, the political landscape of the European Union is on the verge of profound transformation. The result will likely be significant economic change throughout the Union, bringing political conflict among member states in its wake. The opening of the EU to new member states in the East will result, in the short term, in lower per capita income and a higher proportion of the Union's population engaged in agriculture. This development will necessitate a revision of the nature and scale of the two EU policies that consume the largest share of the Union's budget – the common agricultural policy and the regional policy. It will also have far-reaching consequences for income distribution throughout the EU.

Enlargement will also lead to significant EU-wide changes in economic structure, as the new member states begin to compete with existing members and specialization patterns adjust to the new realities. This process, although destined to prove beneficial in the aggregate, will surely lead to increased migration and the prospect of strained social relations in some parts of the Union. As with any process of market integration, the overall benefit runs alongside a non-negligible income redistribution effect, as some social groups gain and others lose from market enlargement.

Similarly, the political reform of the Union – inevitable if the system is to function effectively after absorbing twelve new members – will entail a new distribution of political and economic power as states seek to protect vital economic interests and to enhance their power *vis à vis* other member states in the new political institutions.

Enlargement and the revision of the EU treaties are complex political undertakings that will impose significant economic costs on member states. This is why the implementation of the Lisbon agenda remains an important objective for Europe: members will have an easier time adjusting to the painful political and economic changes that will come in the wake of enlargement if Europe is experiencing rapid and solid economic growth.

A dynamic economy, therefore, must remain a key objective of the European Union's *political* strategy in the years ahead. Europe must aim for and sustain high rates of economic growth – growth based on employment creation and a strong rise in the rate of productivity. Such growth will result in rising per capita income over the long term, which, in turn, will provide Europe with the resources it needs to maintain the social and cohesion policies that enjoy strong support in many European countries, and which European leaders vowed to maintain in the Lisbon declaration.

Over the past ten to fifteen years the EU's economic performance has been less than outstanding. If Europe is to achieve the Lisbon objectives, member states will have no choice but to introduce fundamental economic reforms. It was recognition of this reality that led to the adoption of the Lisbon agenda in the first place.

The purpose of this book is to analyse key policy reforms aimed at bringing about the kind of economic dynamism Europe so sorely needs. Its contributors, drawn from across Europe, pay particular attention to macroeconomic policy management and structural reform.

Francesco Giavazzi (chapter 4) analyses some of the most controversial issues in macroeconomic management in Europe today. He takes a fresh look at the challenges faced by national fiscal authorities when co-ordinating macroeconomic policies within the budgetary constraints imposed by the Growth and Stability Pact (GSP) and by the European Central Bank (ECB). He also explores the ins and outs of European Central Bank governance in an enlarged Europe, and suggests how to properly interpret significant inflation differentials and large current account deficits in the euro zone.

Assar Lindbeck (chapter 2) turns a spotlight on to structural reforms related to labour markets and the functioning of the welfare state. He maintains that significant reforms are needed to guarantee the viability of social welfare programmes, and to bring them into line with changing personal behavioural patterns, new socioeconomic conditions and the exigencies of deepening economic integration throughout the European Union.

Lindbeck's analysis is wide-ranging. It takes the reader on a journey through the human lifespan from cradle to grave, assessing major welfare and employment policies that affect people throughout their lives – child care, employment and income security, health and retirement insurance, and care for the elderly.

David M. Newbery (chapter 3) proposes another set of structural reforms, this time related to the liberalization of markets for network services with a view to creating a unified market throughout the EU. He concentrates on the electricity and gas industries. Newbery maintains that the economics of network industries necessitates a careful balance between regulation and structural change – especially in vertical relationships – if liberalization is to succeed. The opening-up of the network industries market can proceed if due consideration is given to the management of risk and the sustainability of competition within the reformed industry structure.

My contribution to this volume (chapter 5) assesses the policies that have led to the liberalization and integration of financial markets in the European Union. It demonstrates how the EU's approach to the integration of European banking – mutual recognition with a minimal degree of harmonization – differs from other politically less ambitious procedures such as 'national treatment'. By taking a Union-wide approach, the EU has managed to liberalize the banking regulation regime and to avoid undermining those regulations needed to preserve the soundness of the banking industry. Meanwhile, it has achieved a high degree of integration in the sector.

The unifying theme of this volume is that Europe needs to reform its political institutions significantly if it is to meet its objective of greater market integration – the key to a more dynamic European economy. Economic reform in the framework of existing political institutions has run its course.

European economic dynamism and political transformation go hand in hand. A rapidly growing economy will enhance prospects for the transformation of the Union's political institutions by making institutional reform more palatable to national populations. By the same token, the enhancement of the political authority of the EU is vital at a time when the requirements of continued economic integration have outstripped the capacity and willingness of the national states to meet them.

There is widespread agreement in Europe that the current system of institutional decision-making has reached its limit and needs to be drastically overhauled. As Gérard Roland argues in the first chapter of this volume, the current form of governance, whereby the Commission exercises the power of initiative and the Council safeguards the sovereignty of the member states, suffers from a lack of accountability – the well-known democratic deficit. Enlargement is likely to worsen this shortcoming. It comes as no surprise that the Union has not even attempted to apply this approach to decision-making in the spheres of foreign policy, justice and home affairs.

The prevalent alternative form of decision-making until now has been intergovernmental co-ordination. While this approach solves the problem of accountability and safeguards the sovereignty of member states, experience shows that it leaves much to be desired when it comes to the development of new policy initiatives and often leads to outright paralysis. It has been applied – with very limited success – to some of the items on the Lisbon agenda and to issues related to foreign policy and law enforcement, among others.

The deficiencies of current institutional arrangements highlight the need for a new, streamlined approach to decision-making, especially in view of the Union's impending enlargement. Gérard Roland argues that a presidential system made up of a strong executive with a well-defined set of competencies, and subject to the control of the legislature (the European Council), offers the Union the best chance of moving forward with its agenda.

The contributors to this volume present a variety of perspectives on how Europe's current institutional framework tends to impede economic reform. Several of them come to the conclusion that further, meaningful reform cannot take place in the absence of a drastic overhaul of the Union's approach to decision-making. The introduction of the kinds of new institutional arrangements needed to give impetus to economic reform will require a high degree of national, political integration. It is up to the member states to decide whether the gains to be realized from reform and greater economic integration outweigh the cost in terms of foregone national sovereignty. This represents a considerable challenge for the Union, but one it must meet head on. The alternative is getting bogged down in a quagmire of institutional constraints.

The chapters on macroeconomic policy highlight the importance of Europe meeting this challenge. A new political framework enhancing the democratic legitimacy of the European Commission would go a long way toward strengthening the credibility of the Growth and Stability Pact. It would also lead to increased macroeconomic policy co-ordination and improved governance of the European Central Bank.

Concerning welfare reform, measures in this regard are now generally taken outside the Community framework. In practice, the various national states generate welfare reforms based on domestic considerations. A reformed and more accountable European Commission could take the lead in pushing for faster progress in this area. Yet this prospect alarms some member states – the United Kingdom, for example – that wish to continue to treat social and labour policy as domestic matters. Strengthened common political institutions could make the difference. If enlargement leads to a race to the bottom in such areas as social services and corporate tax rates, member states will have to cede some degree of national sovereignty if an effective solution is to be found. The achievement of this objective will require greater legitimacy for Europe's common political institutions.

Much the same is true in regard to the integration of the market for network services. Effective reform will require decisive policies on interconnection, strong measures to maintain a level playing field and strict limits on state aid to national champions in the sector. Again, strong political institutions and a streamlined decision-making process will be crucial.

Integration of the banking sector has been blocked in recent years principally by two factors: (1) interference by member states in cross-border acquisitions and (2) insufficient harmonization. In the absence of further harmonization, the integration of retail markets will be hard to achieve. Doing so may require measures to override national laws, regulations and traditions. On both counts, institutional reforms will be needed to break the deadlock.

The construction of European political institutions has been a long and complex project that will not be accomplished overnight. Europe remains committed to this objective, even more since the collapse of the Berlin Wall. From its inception, the political construction of Europe has been based on economic integration and co-operation, from the establishment of the common market to the introduction of the single currency. Political integration has always lagged far behind. This pattern continues to prevail some fifty years after the signing of the Treaty of Rome.

As things stand now, a strong commitment to co-operation in the matter of economic reform is needed across the continent. This book provides a wealth of ideas on policy changes that can help bring about a more dynamic Europe, the key to which is a vibrant and flourishing economy. Without such an economy, Europe will be hard pressed to meet the political challenges of the twenty-first century.

The contributors to this book make a strong case for the idea that deeper and wider European economic integration requires a dramatic new political impulse in the form of strengthened, common political institutions. The time has come for the European Union's economic integration to advance hand in hand with the continent's political integration.

# 1 The new governance of Europe: parliamentary or presidential?

GÉRARD ROLAND

## Introduction

Research by economists on institutional aspects of the process of European integration has very much focused either on issues of fiscal federalism or on institutions dealing with monetary policy. A huge literature has developed on these issues (see Baldwin and Wyplosz, 2003 forthcoming). This is not surprising since these are areas in which the expertise of economists is quite developed. In those areas, economic analysis is a powerful tool that brings a strong influence to bear on policy debates.

Currently, the main topic of debate within European policy circles is the Convention on the Future of Europe that was set up by the Laeken summit of the European Council in December 2001. The Convention could play a historic role comparable to the Philadelphia Convention of 1787 that drafted the US constitution. At the heart of the Convention is indeed work on a 'Constitutional Treaty' that would merge existing Treaties but most importantly overhaul the institutional system for the governance of Europe. The Convention is reviewing and preparing proposals for improving the mechanisms by which legislative, executive and judicial decision-making is taking place in Europe.

The need to reform the governance of Europe has been voiced repeatedly and increasingly in the past ten years. The looming enlargement of Europe by ten new member states by 2004 decided at the Copenhagen summit (Cyprus, Czech Republic, Estonia, Hungary, Latvia, Lithuania, Malta, Poland, Slovak Republic, Slovenia) has created a sense of urgency. There is a widespread consensus that the current institutions, initially created for a Europe of six member states, will no longer be adequate for a Union of twenty-five countries and more. The Nice Treaty made decisions relative to the number of commissioners, the number of members of the European Parliament (MEPs) and the decision weights of member states in the European Council. However, it was generally perceived that Nice delayed the more difficult but more substantial questions related to the governance of Europe. Enlargement makes reform more urgent because the inherent weaknesses of today's EU institutions risk being strongly magnified in a bigger Union of twenty-five. There could be a substantial risk of institutional collapse of the whole European construction of the past fifty years. Despite the apprehension in many countries of the risks posed by the uncertain prospects of reform of Europe's governance, the EU is seen as a major success story and apparently the time is ripe for such deep reforms.

What can economists say about the governance problem in Europe? Is this an area of expertise reserved exclusively for political scientists and scholars of constitutional law? In this chapter, I build on the recent literature in political economics (for a survey, see Persson and Tabellini, 2000, forthcoming) that analyses the economic effect of different political constitutions. That literature is still very new but it can shed light on the problems of the governance of Europe debated at the Convention.

In this chapter, I will not focus at all on competences of the Union but on governance issues: for those competences that are centralized at the European level, how should political decision-making (legislative and executive) be organized? What are the tradeoffs between different forms of political governance and what would be the optimal solution for an enlarged Europe? The issue of governance itself cannot be completely separated from the competences that should be exercised at the Union level, and the judgement on the most adequate form of governance depends on the kinds of public goods that one expects will be delivered at the European level. My working assumption, which I will justify below, will be that the enlarged EU will retain its current competences but will or should make significant progress in areas related to foreign policy and justice and home affairs.

In the second section, I go over the issues at stake in the drafting of the European Constitution. The Convention has already reached remarkable consensus on many points, but the issues of how to appoint the European executive and of the checks and balances between various European institutions is far from settled. In the third section, I review the relevant literature in political economics, analysing in particular the tradeoffs between parliamentary and presidential governance. In the fourth section, I argue in favour of presidential governance, with the president elected by an electoral college composed of national parliaments. I argue against the election of the president of the Commission by the European Parliament (EP) but also against the setting-up of a European Congress proposed by Giscard d'Estaing, the chairman of the Convention, and against a 'double executive' with a president of the Council elected by heads of state and a Commission president. Executive powers of the Commission must be strengthened, but so must its accountability both to the member states and to the citizens of Europe.

## The issues at stake in the governance of Europe

The institutions created by the founding fathers of Europe have been the source of remarkable success in the last decades.

### *The success of Europe*

The single market has expanded since 1957 both geographically (from six to fifteen, and soon to be twenty-seven) and in depth via the 1985 programme set in motion by Jacques Delors and European monetary union (EMU). This has brought decades of relative prosperity compared to the previous decades, which were characterized by the two most bloody wars in world history. The introduction of euro notes and coins in 2002 has generally been considered a success. Despite some localized price hikes, the euro's introduction was very smooth and European citizens have adapted to it remarkably quickly.

The EU has played a substantial role in stabilizing the macroeconomic situation in Europe, especially in the 1980s and 1990s. After World War II, the main European economies, the UK, France and Italy, followed very divergent paths. The EU has counteracted important government failures in individual countries and helped to create convergence at low levels of inflation. Without the EU, conditions in Belgium and Italy, for example, may eventually have resulted in Argentinian-type situations. This should be remembered in the context of the problems with the Growth and Stability Pact.

The co-operation of EU countries in EU integration has created a framework of peace within Europe after centuries of wars among the biggest European powers. Peace is one of the main objectives of the EU. Peace is achieved not only via more trade (the internal market), but also by EU members sharing increasingly common goals and values. EU countries will not wage wars against each other. Moreover, conflicts between countries are managed within the EU institutions (the BSE or 'mad cow disease' crisis, the dioxin scandal and so forth) which allow for dialogue and sometimes decisions by EU institutions that indicate an effective transfer of sovereignty to the EU. Enlargement holds the promise of peace on the broader European continent.

The EU has provided an institutional anchor that has allowed Greece, Spain and Portugal to achieve a successful transition from dictatorship to democracy. Participation in the EU has also been a very useful vehicle for modernization in these countries. Europe offers a similar future for potential new entrants who went through decades of Soviet occupation and economic stagnation in the socialist economic system. It is not an exaggeration to say that the favourable example of Europe played a positive role in the third wave of democratization in the final twenty years of the twentieth century.

If we compare the EU to any other supranational institution, such as the UN or the WTO, we must conclude that it has functioned more successfully than these other organizations. This is due to the 'méthode communautaire', or Community method, whereby the European Commission, responsible for promoting further economic integration, has had the responsibility (and also the exclusive right) continuously to initiate European legislative proposals, while the unanimity rule allowed countries to preserve their sovereignty.

The Commission, despite its very small size (an administration of fewer than 20,000 civil servants), has also played a very useful role in its competition policy, forcing national governments to undo decisions that conflicted with the Treaty of Rome. National governments have tended to abide by the decisions of the Commission. Decisions by the Court of Justice in the same direction have also been helpful. The precedence of European law in these matters has been more and more recognized and decisions of the Court and the Commission have generally been enforced. This is surprising, given the fact that the EU lacks any enforcement agencies and relies on national governments and bureaucracies for enforcement of its decisions.