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Germany in the European Union: Economic Policy under Ceded Sovereignty

by

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Abstract: The member states of the European Union have given up sovereignty in quite a number of policy areas and subjected themselves to joint decision-making at the European level. Policy instruments are no longer available nationally in many policy areas, including monetary policy, trade policy, the more important part of competition policy, subsidy control, and a large number of the regulations in the product market, the environmental arena, and the capital market. The maneuvering space for national economic policy-makers has been reduced considerably. In quite a few areas in which decisions are taken with a qualified majority, the member countries can be outvoted and have to accept the decisions taken by others. This paper surveys the new decision space of economic policy of a member state including the latest constitutional arrangement.

Keywords: European integration, sovereignty, EU constitution

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Like the other member states of the European Union, Germany has given up sovereignty in a number of policy areas and subjected itself to joint decision-making at the European level. This means that many policy instruments are no longer available nationally. From a historical perspective, the number of such instruments that are no longer at the disposal of German politicians and policymakers in other EU countries as a result of ceding national sovereignty to the EU level is quite impressive. This trend is manifest in many policy areas, including monetary policy, trade policy, the more important part of competition policy, subsidy control, and a large number of the regulations in the product market, the environmental arena, and the capital market. The maneuvering space for national economic policy-makers has been considerably reduced. More and more, the efficiency of policy instruments is coming to be judged in the European context. In quite a few areas in which decisions are taken with a qualified majority, the member countries can be outvoted and have to accept the decisions taken by others.[1]

Trading National Sovereignty for the Benefits of Integration

The most prominent policy area that has recently been assigned to the European level is monetary policy, but many other policy instruments, of

[1] I appreciate critical comments from Richard Baldwin, Akram Esanov, Eirik Jones, Rolf Langhammer, and Jürgen Stehn.

no lesser importance, in quite a few policy areas have been shifted to the European level. Because the notion of a common market lies at the core of the economic union, a wide range of barriers for the free movement across borders needed to be abolished by harmonizing important aspects of the institutional framework of the national economies, or simply by mutually honoring each member state's internal rules and regulations, for instance in licensing products.

The basic economic motivation for giving up national sovereignty derives from the benefit–cost analysis that every country carries out: the advantage of European integration for the individual member country substantially exceeds the lost opportunity of its being able to make independent decisions on economic policy issues. More specifically, the advantage consists in sharing a larger market for sales of products, allowing more options for consumers with respect to a wider variety of products, enjoying efficiency and specialization gains for the member states, and reducing trans-frontier externalities between national decisions. European integration, however, goes beyond these more or less functional economic reasons for establishing a common market in the strict sense. The ultimate motivation for beginning and sustaining European integration has been, and remains, the possibility to solve problems within a common institutional framework instead of going to war over them. Economic integration is thus used as a vehicle for political integration.

European integration has been a continuous process with many consecutive steps with respect to both the countries involved (widening) and the areas or intensity of integration (deepening). The EU started with the European Coal and Steel Community in 1951 and the European Economic Community (Belgium, France, Germany, Italy, Luxembourg, and the

Netherlands) in the treaty of Rome in 1957. The United Kingdom and the Scandinavian countries put up an alternative model, the European Free Trade Association (EFTA), in 1960; however, this eventually lost ground to the EEC. European integration continued with the northern enlargement in 1973 (Denmark, Ireland, and the United Kingdom), taking in the most important EFTA counties, and the southern enlargement in the 1980s (Greece in 1981, Spain and Portugal in 1986) and the entry of the so-called neutral states in 1995 (Austria, Finland, and Sweden). In May 2004 the European Union of 15 was enlarged to a union of 25, including eight central and eastern European countries. The EU-25 will have a GDP of €9.2 trillion, nearly as much as the United States. It represents 455 million people.

Over the last five decades, then, European integration has proved to be quite attractive for nations outside the European Union. Soon, probably in 2007, Bulgaria and Romania will join to form the EU-27. The successor states of the former Yugoslavia and Albania are likely to become members at some point in the future. For Russia, Belarussia, and the Ukraine too some form of association will probably be found. Entry negotiations with Turkey may be opened up within the next several years. This, however, raises the question of where Europe sees its boundaries, and whether Turkey as a member may not imply such an overstretch of the European Union that it will either break up or require a much more intense integration of the core, thus again running the risk of a breakup. Of the European countries, only Switzerland, Norway, and Iceland look set to remain outside the EU.

With respect to the areas of integration and the process of deepening, the germ cell was the European Coal and Steel Community of the Six in 1951,

which then was extended to the common market of the six for all products. This consisted of a customs union without any tariffs between the member states, a common external tariff, realized in 1968, and a common trade policy; a common agricultural market with the common agricultural policy was introduced in 1962. Over time, the product market segmentations were reduced or even abolished, for instance by not attempting to harmonize all aspects of life but instead accepting the legal setting of the other member countries according to the country-of-origin rule or the principle of mutual recognition. The Cassis de Dijon ruling of the European Court of Justice meant that different legal settings could coexist and compete with each other (see below). Except for the northern and southern widening of membership, the Community did not make much progress in the 1970s and the early 1980s with respect to the areas of integration.

Then in 1985 the Delors Commission came up with a White Paper; this permitted the 12 members to sign the Single Act, which became effective in 1987, containing a blueprint of about 270 measures to create a single market and do away with national segmentations. At the end of the 1980s controls on border-crossing capital flows, which were still in effect in some major countries such as France at that time, were abolished as a necessary preparation for the proper functioning of the monetary union. The late 1980s were also characterized by the deregulation of the network industries, including telecommunications, the postal service, and power transmission. The Maastricht Treaty of 1993 brought about the establishment of the European Union, replacing the former European Community. Its main aim was to establish the monetary union, but it also introduced political and social aspects of integration, including European citizenship, a common foreign and security policy, and internal security.

Applying the review clause in the Maastricht Treaty, the Amsterdam Treaty (1997) strengthened the Union's powers in judicial cooperation, the free movement of persons, foreign policy, and public health. Finally, on January 1, 1999, the euro was introduced as a legal tender for book transactions in 11 member states; the member countries' exchange rates were irrevocably frozen. Monetary authority was transferred from the national central banks to the European System of Central Banks (ECB) in Frankfurt. The euro emerged as currency in 2002.

Replacing the Deutschmark with the Euro

Germany has been an ardent promoter of European integration. Economic and political integration into the institutional framework of the Western nations not only paved the way for the country to become a fully fledged member of the international community, and acted as a shield of protection in the days of the cold war: it was also seen as an anchor, giving stability to the values and the orientation of German society and the political process. Giving up national sovereignty to the European level was not a problem for postwar Germans, for whom nationalism had lost its attractiveness and national pride was not, as in other European countries, a central value. Only in one area in the monetary domain did the delegating of decisions to EU level prove hard for the Germans: in giving up the Deutschmark.

To Germans the DM was a stable currency. Although its purchasing power of 1948 had been reduced to a quarter by 1998, the last year of the DM era, it had still lost less than other currencies in Europe and less than the US dollar, which had fallen to 15 cents over the same period. Germans had confidence in the Bundesbank and found part of their identity in the Deutschmark. The Bundesbank was the guarantor of a stable money, and a

stable money was an important value for the Germans who had two major inflations in their collective memory: the hyperinflation of 1923 and the currency reform of 1948. In the hyperinflation of 1923 the Reichsmark was devalued at a tremendous speed. As fathers and grandfathers would tell their children and grandchildren, money was devalued at such a rapid pace that wage-earners had to spend their wages immediately after they were paid, because within half a day their real value would have halved. When the inflation was finally stopped by the introduction of the Rentenmark on November 16, 1923, the exchange rate was 4.2 trillion marks to the US dollar—i.e. 4,200,000,000,000 marks. Savings were destroyed, pensions devalued, lives ruined. In the currency reform of June 20, 1948, it was made explicit that the suppressed inflation since 1936, using price and wage controls to finance military and other expenditures, had produced such a money overhang that the existing money had to be declared invalid. Each German received 40 marks of the new currency in June and another 20 marks in August. Private deposits and private credits (or liabilities) were exchanged at a ratio of 10 Reichsmarks to one Deutschmark, and were partly blocked; they were effectively exchanged at the rate of 6.5 to 1. Credits of the state and of banks became extinct. Wages, housing rents, and the new pensions were changed at a ratio of one to one. Thus, the average person lost nearly all his savings again, and hence his savings for old age, for the second time within 25 years. It is because of this experience that stable money ranks high in the scale of priorities for the average German, and that there was quite a reluctance to give up a monetary arrangement that had succeeded in providing the monetary stability desired so desperately.

The acceptance of the euro as a common European currency has brought many advantages. For the average citizen, it is possible to travel in Europe now without the nuisance of changing currencies—and Germans like to travel during their ample vacation time. For consumers it has become easier to buy abroad. For the German export industry, a common currency has meant that it can enjoy an export area covering the main part of Europe without any disturbing exchange rate changes. Transaction costs in the capital market have been reduced. Moreover, politicians like Kohl are convinced that the euro is an important symbol of the bringing together of Europeans from all the member countries.

On the other hand, there are disadvantages. Monetary policy instruments such as setting the interest rate for short-term money, providing liquidity to the economy, and steering the money supply have been shifted up to European level. These decisions are now made within the Governing Council of the European Central Bank, where a simple majority is required. Germany and all other members of the euro area have just one vote each. Moreover, neither members of the Executive Board nor governors of the 12 national central banks of the euro area, i.e. the members of the Governing Council, can consider themselves as representatives of their country. German monetary policy with its rich tradition of the Bundesbank has ceased to exist. The only comfort that Germans have is that the European Central Bank was modeled along the lines of the Bundesbank, thus transferring the credibility and reputation it had especially among the German population to the new institution. Although Germany is the largest economy in the euro area, producing a third of the area’s GDP, and thus has some impact on the economic variables of the common currency area, the ECB cannot possibly differentiate its policy instruments to the specific

economic situation in Germany. This became apparent in the years of stagnation 2001–2003, when both the GDP growth rate and the increase in the price level were lower in Germany than in the other countries of the euro area. The ECB has to orient its policy to the common consumer price index of the euro area as a whole, the harmonized index of consumer prices (HICP).

The nominal exchange rate, which may have been used as an instrument of adjustment in extraordinary circumstances, such as asymmetric shocks, is no longer available. Adjustment now must come about by a change in the real exchange rate, i.e. in the relative price between exportables and importables or between tradables and non-tradables. This requires institutional changes that make the economy more flexible. This loss of sovereignty shows up in the substitution of real exchange rate changes for nominal exchange rate variations. Looking at the nominal exchange rate, the issue of a loss of a policy instrument may be more an academic rather than a public policy question, anyway. First, a central bank cannot determine the price level and the nominal exchange rate simultaneously. If the price level is specified, the exchange rate will follow in the long run according to purchasing power parity. Whereas smaller countries may take the monetary policy of another country as an anchor and peg their exchange rate to it, larger countries or regions of the world such as Europe would not be inclined to follow someone else as a monetary leader. Second, it is highly questionable in the post-Bretton Woods era whether a larger country can consider the nominal exchange rate as a policy variable anyway. The exchange rate is influenced by the markets, i.e. by trade flows, capital movements, and expectations. Capital flows and expectations make the exchange rate volatile, so it is fair to state that a central bank

cannot determine the nominal exchange rate: it is constrained by interest rate parity. The most it can do is to lean temporarily against the wind.[2]

But the concern of Germans with the new common currency was not only that the monetary policy instruments were migrating to the European level. An equally strong fear, if not a greater one, was that the other member states of the euro area would not attach the same importance to price level stability as Germans had in the past and as most of them still do today, and that the "Club Med" countries, with a supposedly less strict preference for monetary stability, would push for an easy money policy and take a much softer stand on price level stability. Germans feared that, in the struggle between a stable money and softer financial constraints for the state, or in the presumed conflict between a stable money and less unemployment (if you believe in the Phillips curve), other member states would give preference to other targets, e.g.for fighting unemployment by expanding the money supply, rather than to the stability of money. It was feared that the European Central Bank would have a different reaction function than the Bundesbank and that its institutional environment would be prone to a laxer monetary policy.

With these concerns in mind, the European Central Bank was conceived as independent. Article 105 of the EU Treaty defines the main objective of the European System of Central Banks (ESCB) as follows: "The primary objective of the ESCB shall be to maintain price level stability." Other target, such as supporting employment, are only secondary and conditional with respect to the target of price level stability. "Without prejudice to the objective of price level stability, the ESCB shall support the general

[2] The central bank can, of course, depreciate a currency by an excessive supply of money.

economic policies in the Community with a view to contributing to the achievement of the objectives of the community as laid down in Article 2" (Article 105). Article 2 defines the task of the Community in general:

"to promote...a harmonious and balanced development of economic activities, a high level of employment and of social protection, equality between men and women, sustainable and non-inflationary growth, a high degree of competitiveness and convergence of economic performance, a high level of protection and improvement of the quality of the environment, the raising of the standard of living and quality of life, and economic and social cohesion and solidarity among Member States."

Although members of the Executive Board are all appointed by common accord of the heads of state, and the national governors by the national governments, they tend to internalize the ECB's mission as their guideline. Reappointment of members of the Executive Board is not possible. It must be acknowledged that the ECB succeeded in delivering a stable money for the euro members in its first five years. Inflation expectations, as measured by survey data or financial market indicators, have remained consistent with the ECB's definition of price stability. This becomes all the more remarkable if we take into account that the ECB had no track record of formulating monetary policy at the beginning, when it was faced with a euro area economy that was being hit by repeated upward price shocks. As a result of all these shocks, HICP inflation has been above—and sometimes significantly above—2 percent for quite some time. But inflation has always bounced back following these shocks.

Nevertheless, not everyone in the European Union was convinced by the monetary union. The Swedes voted in 2003 to stay out of the monetary

union; it may take a decade until a new referendum can be put to the citizens. In Denmark, too, a referendum in 2000 brought a “no.” And it remains uncertain whether and when the United Kingdom will join. Some of the new EU members seem interested or even eager to join early, in order to participate in the euro’s credibility and enjoy low interest rates. But they may need the exchange rate as a buffer for longer time.

The Germans welcomed the euro when it was finally introduced in 2002. In January 2002, 67 percent responded that they were personally happy or very happy that the euro had become their currency, whereas only 23 percent said they were unhappy (and 10 percent were undecided), according to the Flash Eurobarometer of the EU Commission. This percentage, however, has declined; it was only 44–47 percent (with 9 percent undecided) in November 2003. Thus, the ECB and EU politicians cannot take it for granted that the euro will be widely supported by the population; efforts will have to continue to convince the public of its merit.

The Stability Pact: Restraint on National Budget Policy

The ECB’s success in the euro’s first years is no guarantee of a stable money in the future. This will depend on the behavior of the central bank, the stability culture, and the institutional setup. A common European currency is not without potential conflict. One of the points of contention is the dichotomy between the Europeanized money and national political decision-making, the other is the possible confrontation between monetary stability and fiscal laxity.

The common monetary policy has been shifted to the union level and must be oriented toward price level stability in the monetary union as a whole.

Consequently, it cannot take into consideration specific national conditions. In a monetary union, the monetary “suit” is no longer custom-tailored for each nation: one size must fit all. But political decision-making, for instance in budget policy, remains with the nation states. This is a major characteristics of monetary policy in an economic union, unlike the relationship of a central bank to the political authority in an individual country. This condition can be a source of conflict that may cause problems to the European Monetary Union in the future. Some consider it a massive potential conflict, one that may even break up the currency union (Feldstein 1997). Even if countries are in a different stage of the business cycle, with one in a boom and another in a recession, if they experience an asymmetric shock and get stuck in a self-inflicted crisis, they must cope with the same monetary policy. But monetary policy is still judged in national political decision-making processes, since a political union does not come into existence simultaneously with a monetary union.

Thus, a potential for conflict, additional to and different from the situation in an individual country, inevitably arises in a monetary union between a common monetary policy and national economic interests. One may argue that the interest of one of the member countries can be neutralized by the other countries, but one also can take the view that the common monetary policy must find acceptance in all countries as long as political decision-making processes are national. To put it differently, in a monetary union quite a bit of political discipline is required from a member country in crisis to accept a monetary policy that is oriented toward European price level stability, but, by necessity, not to the specific economic situation in the individual country. If, however, the country in crisis were allowed to have

its way and getting an easy monetary policy adopted, inflation throughout Europe would result.

In addition to this potential conflict between the Europeanized currency and the national interest, there is a possible confrontation between a stable money and distress in the public finances. By entrusting an independent European central bank with the authority to steer the money supply, i.e. to set the interest rates and determine other monetary policy instruments, the process of money creation in the euro area is not in the hands of politicians: it is depoliticized, as it was during the time of the Bundesbank. But even if it is conceived as being politically independent, a central bank tends to be exposed to political pressure. Such pressure may originate from countries facing severe economic problems. Member states of the monetary union with high government debt will be interested in low interest rates, a lax monetary policy, and a slightly higher inflation rate than that anticipated by financial markets, because such a scenario would ease their budgetary situations, especially because debts would melt away in real terms. Political pressure will be exerted on the European Central Bank if the economy of a highly indebted state is hit by recession and faces severe financial difficulties. The issue is not that a country will deliberately follow a policy of excessive deficits in order to force the European Central Bank eventually to step in as lender of last resort; it is that a long-run process of debt accumulation may occur as a result of political weakness, so that eventually the European Central Bank will have no other option than to adopt a soft monetary policy.

Historically, it has not been possible to maintain a stable currency when the finances of the state are in disarray. High government debt tends to lead to financial disorder. In a monetary union an important controlling

mechanism of fiscal policy is no longer available: the national currency can no longer be devalued when a country runs a high balance of payment equilibrium, often together with a budget deficit. For example, Portugal had an unusually high currency account deficit of 10.4 percent in 2000. Before monetary union this would have required a devaluation of the escudo. The EMU countries, however, can have higher current account deficits. They benefit from increased capital mobility as long as there are surpluses elsewhere and the Union's current account position does not degenerate.[3] They can take the free-rider position with respect to price level stability, for instance with high public debt.

Admittedly, the treaty has a no-bail-out clause in Article 103, according to which a member state cannot expect to receive financial support from other member states or the European Union if it is in financial distress. If this bailout rule is credible, financial markets will punish the country lacking fiscal solidity by imposing higher interest rates. This threat represents an incentive to keep the public finances in order. To some extent this mechanism is indeed operating. However, Article 100, allowing financial assistance in the case of economic crisis and natural disasters, may be interpreted as a type of stand-by. If transfers have to be made after all—in spite of liability being excluded—then the donor of transfers, as well as the recipient, may develop an interest in keeping these transfers as low as possible, replacing them by a rather lax monetary policy. As national safeguards against governmental financial distress either do not exist in all member states or are not sufficient to shield the European Central Bank from political pressure in a situation of unsound public finances, the

[3] Jones (2003) shows that the variance in the country's current account positions has increased with the monetary union.

requirement of sustainability of the government's finances is a major issue in a currency union. This is the role of the Stability and Growth Pact (Article 104). Its overriding objective is that governments remain solvent. Usually, this is interpreted as requiring stationarity of a tolerable level of debt: the debt/GDP ratio has to remain constant. In the protocol of the Maastricht Treaty, this limit has been set at 60 percent of GDP. This target was chosen at a time when the debt level of most of the potential euro members was below that threshold and when 60 percent appeared as a limit that would not become relevant so quickly. The restraint for a debt level of 60 percent implies a limit for an excessive deficit of 3 percent of GDP if nominal GDP growth is 5 percent and real growth at 3 percent.[4]

The excessive deficit procedure itself is specified in Article 104 in general terms. Several consecutive disciplinary steps will be taken if a country runs an excessive deficit. The most important ones are: a report by the Commission; a decision of the Council (with qualified majority) concerning whether an excessive deficit exists; recommendations to the member state; a warning to the member state if it fails to put into practice the recommendations of the Council; and the request of additional information for the Council; then the request of a non-interest-bearing deposit; and eventually the imposition of a fine.[5] Taking into account the guidelines in the Resolution of the Council on the Stability and Growth

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[4] This follows from $\frac{D_{t+1}}{Y_{t+1}^N} = \frac{(D_t + \dot{D}_t)}{Y_t^N} \cdot \frac{Y_t^N}{Y_{t+1}^N}$. Solving for $\dot{D}_t / Y_t^N$ and setting D/Y ^{N} for both periods equal to 0.6, we get 0.03 for the budget deficit in relation to GDP. D_t denotes debt in period t, $\dot{D}_t$ the change in debt, and Y^N nominal GDP.

[5] The non-interest-bearing deposit will be converted into a fine after two years if the budget deficit remains excessive.

Pact of 1997 and the Council Regulation on the Implementation of the Excessive Deficit Procedure of 1997, the following rules apply to situations in which a budget deficit surpasses 3 percent of GDP. (i) A real decrease of GDP on a yearly basis of at least 2 percent is viewed without any further argument as an exception; the 3 percent limit then is not binding. (ii) In the case of a fall of GDP in the intermediate range of 0.75–2 percent, a set of discretionary decisions of the European Council has to be made. The situation may be regarded as exceptional if the country can demonstrate that its recession is exceptional in terms of its abruptness. (iii) If GDP falls by less than 0.75 percent, an exception cannot be claimed.[6]

It was not possible for the Council to agree upon an automatic excessive deficit procedure when the common currency was established. Now, the excessive deficit procedure contains many discretionary steps. The determination of an excessive budget deficit remains uncertain if a member state, after being forced to delay restorative measures by a formal resolution, does then take appropriate measures. Whether the measures taken are appropriate is also decided by the European Council. These discretionary steps raise the question of whether the Stability Pact will be effective. Moreover, there is a conflict of roles, since those who are responsible for the excessive budgetary deficit will also be the ones to define it and to vote on the fines. The pupils write their own grades. Reading through some of the documents, for instance the guidelines of the Stability Pact of 1977, where, for instance, the member states "commit themselves to respect the medium-term budgetary objective of close to balance or in surplus…," one cannot but have the impression that some of

[6] The rule of the third case apparently was not applied by the Council when the excessive deficit procedure was not opened against Germany and France in November 2003

the documents have been produced to ease the anxiety of the German population prior to the founding of the European Monetary Union.

It is embarrassing that Germany was one of the countries violating the Stability Pact in 2004, for the third year in a row. Germany had pushed for the Stability Pact to be adopted by euro member countries to make sure that excessive deficits would be avoided by those countries. All EU countries accepted the basic idea of the pact, and Germany’s membership was to some extent dependent upon such a pact, as Germany’s Constitutional Court had given the green light for membership in the monetary union only under the condition of a clear and long-term commitment to low inflation rates and stability.

Many statements were made in 2002 and 2003 by the German and French finance ministers, the German chancellor, the French president, and also the president of the EU Commission, shedding doubt on the wisdom of the Stability Pact. All these statements can be interpreted as attempts to soften the restraint of the Stability Pact. In fact, in November 2003 the finance ministers decided in the Econfin Council not to follow the proposal of the EU Commission to initiate the excessive deficit procedure against France and Germany, in spite of the fact that the two countries had a budget deficit higher than 3 percent of GDP for three consecutive years and were not in recession. This not only called into question the preconditon of the two fiscal criteria of 3 percent for the deficit and 60 percent for the new EU member countries, but also was an invitation to all euro area members to adopt loose fiscal policies. Moreover, it is difficult to explain to new EU members that want to join the monetary union that entry criteria have to be satisfied. Once the financial markets become aware that the restraint of fiscal soundness in Europe is being abandoned, and that a situation is likely

to develop that is unsustainable (and taking into consideration the implicit debt of the social security systems in the three largest continental countries), the external value of the euro may very well be at risk. As is well known, the mood of financial markets can change quickly. Thus, there is a definite risk that the stability of the new common money may be endangered by the decisions of politicians, in spite of the independence of the European Central Bank. The year 2003 may go down in history as the year when politicians redefined the conditions of the European Monetary Union in their favor, thereby weakening the ECB (see below on the Convention).

The Expected Impact of the Common Money

A common money will change the prevailing economic conditions in the member countries of the euro area both in the product and factor markets and in the institutional setup of these markets. Thus, the euro will stimulate the processes that will reduce market segmentation in the capital market, leading to a deeper market that can be more competitive internationally. The business cycle will become more synchronized for the simple reason that an important policy instrument will affect the countries symmetrically, except for the remaining differences in the monetary transmission channels. However, the properties of the business cycle depend on many factors, such as the structure of the economy in terms of locational specialization and trade linkages within Europe or with non-European countries. These factors may offset, and even overcompensate for, the synchronizing effect of the euro.

High hopes were placed on the euro for straightening out some of the rigidities of the labor market in the large continental European countries.

The argument is that prices and costs are more directly comparable in a currency union, and that therefore price and cost competition will be enhanced. Owing to the increased mobility of capital, firms have the option to respond to an inflexible national labor market by moving elsewhere. This will put pressure on the political process to redefine the institutional setup of the labor market and to make it less rigid. In a way, the euro, once established, should improve ex post the optimality conditions that are, in theory, required as necessary conditions ex ante for the start of the currency area. To what extent this is likely to become true will depend on many factors, one of which is whether the forces aiming for a more centralized and more social democratic labor market will win the upper hand. There is no question that a currency union needs a flexible labor market, but there is no guarantee that this will come about in the major continental European countries.

It can even be argued that German trade unions have gained an additional degree of freedom in their wage policy because they no longer have to take into account the direct reaction of the Bundesbank to their wage policy. The ECB is unlikely to respond to the wage policy in a single member state of the euro area. Accordingly, Hancké and Soskice (2003) claim that some smaller countries are now able to use tripartite wage policy to undercut Germany, while the wage-controlling role of the Bundesbank against German unions has been lost with the passage of power to the ECB. As an implication, the auhtores recommend a type of central bargaining in the euro area that would take the form of an agreement on inflation coordination in the major economies of the euro area.

This argument, however, overestimates the role of the Bundesbank. It is true that the Bundesbank did not accommodate the nominal wage increases

by ordering an increase in the money supply, as was the case in Sweden, for instance, before the 1992 crisis—leading to a depreciation in the krona which undid the nominal wage increase in real terms: people had a wage illusion. The Bundesbank aimed for a stable price level; it stabilized inflationary expectations, keeping nominal wage increases low by international comparison and preventing a steeper rise of the price level resulting from the wage increase. But the Bundesbank was not able to prevent wage overshooting in real terms and a stepwise increase in unemployment. It is too simple to base economic policy on the macroeconomic Phillips curve, which cannot be taken as a given relationship that remains constant over time. If the argument is presented in terms of unit labor costs, i.e. that some countries now will have a lower increase in their unit labor costs, it must be noted that unit labor costs are not an appropriate measure of wage policy if unemployment is increasing because this raises labor productivity artificially. Besides, unit labor costs on a national currency basis rose much more in Germany in the 1990s during Bundesbank times than in most other countries.[7]

What is more important, trade unions are under a more effective constraint than that of the currency union: namely, the fact that the mobility of capital, technology, and highly qualified labor has increased considerably worldwide. Firms have an exit option which implies domestic job losses, and this restrains the wage demands of the unions. At the same time, governments no longer are able support unemployment schemes to the same extent as in the past. It seems that up to now, trade unions in the euro area have tended to demand higher wage increases in real terms in line with

[7] The rate of change of unit labor cost in Germany was 3.1 for 1990–95 and 0.7 for 1995–2000, in contrast to 0.2 and –0.5 for the United States (US Department of Labor 2003: table B).

productivity growth. This strategy is not appropriate for the reduction of unemployment; but at the same time, if applied, it does not aggravate the existing unemployment. Indeed, it is cost neutral, as long as the trade unions do not succeed in inducing the government to raise its expenditures on unemployment programs.[8]

Another issue that comes to the forefront is whether the common currency requires the coordination of macroeconomic policy of all euro area member countries. This question is deemed relevant since monetary policy has now been Europeanized, whereas the other areas of macroeconomic policy remain at the national level. One approach is to limit negative spillovers between the different macroeconomic policy areas, as in the Stability Pact. Thus, the Stability Pact can be viewed as a specific form of coordination, i.e. coordination by constraint. Other attempts at coordination represent a form of atmospheric coordination including mutual information. This means that national policy-makers are informed about what is intended elsewhere and start from a common frame of reference. In part, coordination will have to rely on moral suasion, for instance if a country with high growth rates benefits from the low interest rates of the ECB and is not willing to reduce its governmental absorption. Some groups, especially in France and among socialists, voice strong support for an economic government as a counterweight to the ECB. However, most of the coordination philosophy is based on extremely simple and naive Keynesian ideas of controlling and fine-tuning aggregate demand over the cycle; inside and outside lags are neglected. The political process in the member states seems unable to smooth government expenditures over the

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[8] On the argument that a still-independent Bundesbank would have given Germany lower interest rates than the ECB has delivered.

cycle. While additional spending in a recession is seized wholeheartedly by the political process, reducing demand in a boom is unlikely to take place. Thus, I am skeptical about more intense macroeconomic coordination at the European level.

Assigning the Tasks: Which Competence to Which Level?

More straightforward and basic to the European integration process than the introduction of a common currency is the integration of product and factor markets, because this refers to the real side of the economy. Here, in the ceding of sovereignty, three important issues have to be decided: (i) Which decisions should be taken at which level? (ii) Which body should decide? And (iii) which decision rule, e.g. qualified majority or unanimity, should be applied?

The Four Freedoms

The core of European integration is the single market and its four freedoms: the free movement of goods, people, services, and capital. This gives a first answer to the assignment issue of which decision in an economic union should go to which level. According to the principle of the free movement of goods, all obstacles to the common market are to be dismantled. Member states no longer have the option to erect barriers to trade, barriers including not only tariffs and quantitative restrictions, but also national regulations representing barriers to border-crossing flows of goods. Only in cases where products are hazardous and damaging to health, to safety, or to the environment does this principle not apply (Article 30 of the EU Treaty).

The principle of the free movement of people specifies that EU citizens have the right to move and reside freely within the territory of the member states in order to work, study, seek employment, start a business, or live, for instance as a pensioner. They should receive the same treatment in all member states; i.e., it is not permissible to discriminate against EU citizens on account of their nationality. Today this right has been implemented in all member states. Free movement also means that border checks on individuals are to be abolished; this has been achieved in the Schengen countries (named after the town where the agreement was signed) to which Austria, Belgium, Denmark, Finland, France, Germany, Greece, Italy, Luxembourg, the Netherlands, Portugal, Spain, and Sweden belong (as of 2003).

According to the principle of the free movement of services, services offered in one member country can also be supplied in the other member countries. The free movement of services is especially linked to the right of establishment; individuals have the right to establish businesses anywhere in the European Union.

Finally, the free movement of capital implies that all segmentations of the capital market that hinder border-crossing capital flows can no longer be justified.

From these four freedoms, and from the concept of the internal market, it follows that all national decisions and the corresponding policy instruments that can erect barriers to the free border-crossing flows must be given up. What is essential for a single market, i.e. for all border-crossing activities, has to be addressed in some form of a common institutional setup.

Federalism and Subsidiarity

But European integration goes beyond the concept of a single market aiming at an economic and political union. The additional issue concerns which competences have to be shifted to the European level in addition to the very essentials of guaranteeing the free flow of goods, people, services, and capital in a single market. The economist's answer to this question of the optimal degree of decentralization or centralization is the concept of fiscal federalism. As this concept suggests, an economic activity should be assigned to those organizational levels of government that can best deal with it. In this assignment of tasks, one should start with the lowest level. This is what the subsidiarity principle requires. The reasoning behind this principle is that a more decentralized unit has better information on preferences and on the structure of problems. The lower level can deal better with local or regional issues; it can also respond more flexibly. Higher levels of organization tend to have less information on local matters; and distortions in collecting information are more likely to occur. In the spirit of this approach, regional problems should come under the responsibility of the regional authorities, problems with a national dimension should be decided at the national level, and economic problems of a European dimension such as trade policy should be assigned to the European level.[9]

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[9] In the assignment of tasks, one has to make sure that the lower levels cannot free-ride on the higher levels, for instance through a no-bailout clause or through limits on the level of permissible debt. Compare, for instance, the experience with the provinces in Argentina prior to the breakdown of the currency board.

Policy Areas at the European Level

Following the requirements of the single market and the subsidiarity principle of the economic union, a number of policy decisions have to be centralized in the European Union, among them trade policy, competition policy, and subsidy control. Trade policy is carried out at the European level, since the European Union is also a customs union with a common external tariff, which incidentally is now 3.5 percent for all trade in industrial products. Other trade policy instruments like anti-dumping are applied uniformly at the EU level as well. The European Union has a Common Commercial Policy vis-à-vis third countries and the World Trade Organization (WTO). Competition policy, which has to make sure that market processes in a single market are not distorted by the market power of firms, must be directed to the single market as a whole. Thus, the abuse of market power in the EU and the creation of new dominating positions (monopolies) by mergers have to be controlled at the European level. Cases affecting only an individual member state are left to the national authorities. Subsidy control has a similar task, i.e. to prevent competition in the single market from being distorted by state aids of the member countries. The Commission controls national subsidies and has established a respected power in this domain.

The Common Agricultural Policy (CAP) owes its existence only indirectly to the single market. Assuming that there were national agricultural policies in the traditional form, i.e. where different levels of national subsidies applied to the production of agricultural goods in different countries, then, in order to prevent distortions between agricultural production in the various countries, one would need to have separate border controls for these products. But it is not practical to have separate border controls in a

single market for specific products: that would require determining at each border which trucks were carrying agricultural products. Therefore, to prevent such border controls, the union would need to have a single agricultural market. But since this sector might not be strong enough to survive exposure to international competition, recourse has been taken to external protection. The Common Agricultural Policy, undertaken at the European level, defines reference prices for agricultural products and accordingly pays subsidies to farmers. It uses quantity restrictions for production, for instance milk quotas. It also pays subsidies for exports and uses a variable import levy to bring the price of imported products up to the European level.[10] Agricultural policy absorbs nearly half of the EU budget. In recent years, direct price supports have been partly substituted by income transfers. It has been widely debated to what extent subsidies and agricultural policy can be nationalized. This option would require a switch from direct subsidies to income transfers for farmers. The nationalization of agricultural policies would also be feasible, if minimum requirements for state aid could limit the potential distortions between member states.

Other areas in which decisions have to be centralized are those where severe distortions of competition or in the allocation of resources would arise. For instance, large differences in indirect taxation would imply arbitrage on the goods markets by consumers and firms. For this reasons, in indirect taxation in the single market countries a minimum rate for the value added tax has been set that applies to most commodities. Even though the destination country principle holds for the value-added tax, whereby the tax is paid by the final consumer, a minimum rate reduces distortions that may arise from the exemption for direct mailing.

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[10] With rising world market prices, this instrument

In contrast to these centralized areas, the other policy areas are allocated to the national level. These include taxation; wage policy in those countries where wages are not determined by the markets, i.e. where they are negotiated by the social partners; the organization of the health, education, and culture sectors; and the social security systems, including pensions, health, and unemployment insurance (figure 1).

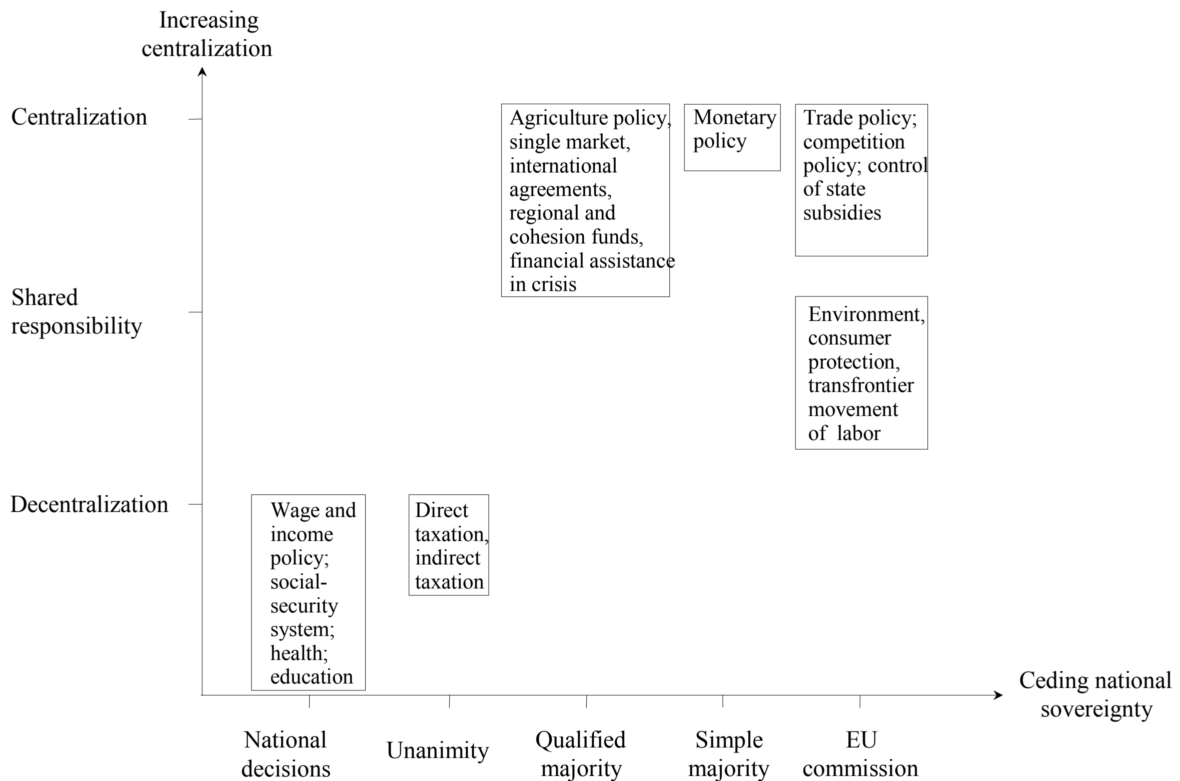
Tendencies of Centralization

The two criteria of the single market and subsidiarity set general guidelines for addressing policy problems in an economic union. These criteria, however, may be interpreted quite differently by the political process depending upon the specific issue in question. Thus, the criterion of a public good with a spatial dimension the geographic size of the European Union is a precise concept to apply, for instance, to the issue of global warming, where Europe has to be considered a major player. But in practice, politicians may interpret all sorts of externalities broadly, not least to initiate programs involving expenditures and financing at the European level. Moreover, other goods will be considered so meritorious—the so-called "merit goods"—that they will be put on the European agenda. They open up new sources of financing at the European level and correspond to the preference function of politicians. An example of these merit goods are roads or railway lines which, according to the subsidiarity principle, should be dealt with nationally, once the points of intersection are properly defined. Last but not least, distributional considerations at the EU level are introduced under the heading of social coherence. It is for this reason that, in the observed assignment of issues, some areas take an intermediate position between central and national competence—transport, energy, the environment, and consumer protection, for instance.

In addition to the above mentioned points of contention, there is an ongoing debate on how intensive the regulation by the Commission, for instance through its directives), and how detailed the decisions of the European Court of Justice, should be. From a practical point of view, it has proved to be impossible to harmonize all legal rules of all the different member countries. Therefore, in the Cassis de Dijon case of 1979, the European Court of Justice established the country-of-origin principle, or the principle of mutual recognition. The Cassis de Dijon, a fruit liqueur, is widely used in France to prepare Kir Royale, Kir Archeveque, and Kir Bourgeois. However it was not permitted to be marketed in Germany. By German regulation, the monopoly law on spirits (Branntweinmonopolgesetz) of 1922 required fruit liqueurs to have an alcohol content of at least 32 percent, and thus the alcoholic content of 17 percent in the Cassis de Dijon meant that it was *verboten* (prohibited) to sell this product as a fruit liqueur in Germany. (The logic behind such a law is another matter.) The European Court of Justice ruled that a product legally sold at market in one country of the European Union has to be accepted by other countries for sale. This ruling thus permitted the export of Belgian beer, which is not brewed in accordance with the German beer purity regulations of 1516, to Germany; and it allowed the export of pasta not made from Italian buckwheat flour (durum) to Italy. According to this country-of-origin principle, the different regulations must be mutually recognized and allowed to coexist. The Cassis de Dijon verdict of the European Court of Justice not only holds for goods, but also applies to services, for instance banking and insurance. In the same way, a bank product sold in the United Kingdom can be marketed in Germany under UK laws. This principle has proved to be a can opener for national regulations.

Be that as it may, the European Commission, endowed with the power to regulate, is tempted to use its power and to over-regulate. For instance, in Regulation 1677/88 from June 15, 1988, the Commission defines the quality norms for cucumbers, specifying even their required curvature in quality classes I, II, and III (requiring for instance that the curvature does not surpass 10 mm for a length of 10 cm in quality class I (Siebert 2003). As another example, the European Court of Justice decided in September 2003 that the practice in Germany of not counting the “on-call” time of doctors in hospitals (during which they have to be available in a hospital, but can sleep if not needed) as working hours violated the EU directive on working time. Germany was therefore obliged to change its laws. It is hard to see why all these details have to be uniform from Feira in Portugal to Rantasippi in Finland.

Figure 1: Degree of centralization



Ex Ante Harmonization versus Institutional Competition

In the assignment of competences, two opposing strategies have been followed: institutional competition, and prior harmonization. Institutional competition means that different national institutional arrangements can exist simultaneously in a single market, and that the rules of the country of origin (for a product or a service) are mutually recognized. The implication of institutional competition is the arbitrage of consumers and firms. Consumers vote with their purses and their feet, and firms take advantage of differentials in national regulations. Countries compete for the mobile factors of production, and the emerging institutional setting is the result of an open-ended process. The most important impact of institutional

competition will be to open up markets that have so far been closed because of national regulations.

The conflict between the strategies of institutional competition and prior harmonization is an expression of a deeper conflict of orientation: on a constitutional level, it is the conflict of federalism and centralization. On a philosophical level, it is the conflict between liberalism in the classical or British sense and a more planning-oriented approach. Here we have diverging views on such issues as confidence in the functioning of markets or any type of interventionism; the sovereignty of the consumer or need for his "protection"; the role and the size of the government, the spontaneity of autonomous decision-making; and decentralized processes versus constructivism, or the English case law versus the logic of the Roman law. Europe is in search of its institutions, and the showdown between the British and the French concept of Europe is still to come.

Sharing the Decisions: Which Body and Which Majority?

Besides the question of which issue should be centralized and which should remain at the national level when looking at the characteristics of the issue, the other two important questions of decision-making are which body can take which decision, and which decision-making rule, for instance qualified majority or unanimity, applies to which body and to which issues. The answer that the European Union has found to these questions has led to a system of multi-level governance. Decisions are taken in a complex web of decision-making bodies with complex decision rules.

The Council of the European Union

The Council of the European Union is the central decision-making body. It is made up of the member states and meets in more than twenty different forms, for instance as heads of states (the Council) or as ministers for a specific portfolio (Council of Ministers; e.g. Foreign Affairs, Economy and Finance (the Ecofin), Agriculture, Transport, etc.). The Council in its different forms is the decision-making body in such fundamental questions as changing the treaty subject to ratification in the member states, taxation, and all other issues where unanimity applies. It is also the decision-making body in the many fields where a qualified majority is needed.

Table 1: Allocation of votes in the EU-27

	Population[a] (m)	Votes (pre-Nice)	Votes (post-Nice)
Germany	82.2	10	29
UK	59.6	10	29
France	59.2	10	29
Italy	57.7	10	29
Spain	39.4	8	27
Netherlands	15.9	5	13
Greece	10.5	5	12
Belgium	10.2	5	12
Portugal	10.0	5	12
Sweden	8.9	4	10
Austria	8.1	4	10
Denmark	5.3	3	7
Finland	5.2	3	7
Ireland	3.8	3	7
Luxembourg	0.4	2	4
Poland	38.6		27
Romania	22.5		14
Czech Republic	10.3[b]		12
Hungary	10.1		12
Bulgaria	8.2		10
Slovak Republic	5.4		7
Lithuania	3.7		7
Latvia	2.4		4
Slovenia	2.0		4
Estonia	1.4		4
Cyprus	0.7		4
Malta	0.4		3
Total votes	482.1	87	345

[a]December 2000.- [b]July 1999.

For decisions of the Council, there are three different types of majority according to Article 205.

1. If not stated otherwise, a *simple majority* of votes of the member states is needed. This is 13 out of 25 in the enlarged Union; it was 8 out of 15

member states in the EU-15 up to May 2004. Simple majority, however, is practically never used.[11]

2. For a *qualified majority* in the enlarged EU-25, as of January 2005, 232 out of 321 votes (72.3 percent) will be required.[12] Votes are then assigned to the member states according to the weighting specified in the Treaty of Nice; these new weights have been defined in light of the expected enlargement (table 1). The qualified majority is required in such areas as agricultural policy, trade policy in a narrow sense (on the operative level, i.e. commercial policy except e.g. trade in cultural and audio-visual services), technical and financial cooperation with third countries, the free movement of citizens within the European Union, and technical and anti-discrimination measures. This type of qualified majority is needed for decisions that are taken by the European Council with respect to proposals of the European Commission. In all other cases, it is additionally required that the 232 votes represent the approval of at least two-thirds of the member states, i.e. 17 members (Article 205). A member state has the right to request verification that the member states constituting the qualified majority represent at least 62 percent of the total population of the Union. The blocking minority is 90 votes in the EU-25. In the EU-15 up to May 2004, these figures were 62 out of 87 votes for qualified majority (71.26 percent); the blocking minority was 26 votes. In the case where the majority of member states was also needed, the approval of at least 10 members was required. This

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[11] It applies, for instance, in the Governing Council of the European Central Bank.

[12] Council of the European Union, November 26, 2002, Document 14702/02 EN. In the interim period between the date of accession and December 2004, the old weighting of votes applies, with the weights for the new members defined accordingly. When not all the candidate countries listed in the Declaration on the enlargement of the Union will have joined, as now is the case, the threshold for a qualified majority will move, according to the pace of accession, up from the actual percentage of 71.26 percent to 73.9 percent. The blocking minority will change accordingly.

voting scheme with the pre-Nice weights has been adjusted for enlargement in 2004 until the new weights become effective in 2005. From 2007 on, when Bulgaria and Romania join, 258 of 345 votes (73.8 percent) will be needed for the EU-27. The blocking minority then will be 88 votes and 18 members.

3. *Unanimity* is required in the most important policy areas. In addition, in the case of qualified majority there has been a consensus so far, whenever a vital interest of a member state is involved, not to take votes and to continue negotiation.

Basic decisions require unanimity (table 2). The most important areas where unanimity is needed are: admitting new members (Article 49), indirect taxation (Article 93), direct taxation (Article 95,), the budget of the European Union (Article 269), and fundamental rules (Articles 94, 95). Unanimity is also required in international treaties in trade policy (Article 133), cultural policy (Article 151), industrial policy (Article 157), social cohesion policy (Articles 157, 161), i.e. the regional funds, research and development policy (Article 166), and environmental protection (Article 175). Asylum policy, while respecting international agreements, is under national authority and requires unanimity. This also holds for immigration. From 2004, the procedure of co-decision with qualified majority applies to certain aspects of asylum and immigration policy (Article 67). Of course, the unanimity principle in the area of taxation is at the heart of the question of national sovereignty and political union.

According to the Treaty of Nice, qualified majority voting will apply in some areas where unanimity was required so far. This includes among others legislation on the free movement of EU citizens (except measures

concerning passports, identity cards, social protection, and social security); rules on anti-discrimination at the workplace; common commercial policy, where qualified majority will now also apply to most agreements on trade in services and commercial aspects of intellectual property (except trade in cultural and audio-visual services, educational services, social and human health services, and treaties in international taxation); economic and social cohesion actions outside the structural funds; and some formal procedures such as the appointment of the secretary-general of the Council and the approval of the Rules of Procedure of the European Court of Justice. After the next funding round to be decided in 2007, i.e. around 2014, , decisions and co-decisions on the structural and cohesion funds will be taken by qualified majority and the co-decision of Parliament. Financial assistance to a member state threatened by a serious economic crisis or natural disaster (Article 100) will henceforth be decided by qualified majority. This may very well become relevant in the euro zone when a country gets into financial distress. It softens the no-bail-out clause (Article 103) or can even be in contradiction to it. Together with the weakening or effective abandonment of the Stability Pact, this may change the incentive mechanism to prevent high debt.

A special majority of four-fifths of the member states is needed for determining a serious breach of fundamental rights by a member state.

Table 2: Required majorities

Required majority	*Policy area*
Simple majority	European Central Bank Council
Qualified majority	Agriculture
	Internal market
	Environment
	Transport
	Trade policy in the narrow sense
	International agreements including trade policy in the wider sense (except for some areas)
	Regional and cohesion funds[a]
Unanimity	Harmonizing the legal framework
	Indirect taxation
	Direct taxation
	Admittance of new members
	Culture

[a] After the next funding round (post 2007).

The European Parliament

The European Parliament participates in the different forms of approval, co-decision, and hearing. The approval of Parliament is needed in declarations of fundamental violations of the treaty. The proceedings of

joint decisions according to Article 251 apply to proposals of the Commission to which Parliament submits a statement. On the basis of this statement, the proposals of the European Commission are enacted by the Council. If Parliament alters the Commission's proposals in joint decisions, rules specify how to proceed. The European Parliament does not have the right of initiative.

The European Commission

The Commission is the operating arm of the European Union; it implements policies, creates secondary law, and, together with the European Court of Justice, is the guardian of the treaty. Primary Community law can be established by the Council—or in the case of the co-decision procedure by Parliament and Council—only in those areas that have been defined for joint decisions; where unanimity is required, the power to legislate still rests with the individual member state. The Commission establishes secondary law in the form of regulations, directives, and decisions. Regulations are directly applied; they form part of the legal system and there is no need for national measures to implement them. Directives bind member states with respect to the objectives to be achieved. It is up to the national authorities to choose the appropriate means to implement the directives. Decisions are addressed to a specific member state or to all member states and are binding. Informal procedures and rules of the game play an important role in the decision making of the European Union.

The European Court of Justice

The European Court of Justice is concerned with the interpretation of EU law. The Court also provides the judicial safeguards necessary to ensure that the law is respected. The types of action include actions brought before the Court by a member state against a member state and by the Commission against a member state.

The Binding Character of Legal EU Rules

All these different layers of law are binding for the member states, i.e. for the governments and the citizens of the member states. European law takes precedence over the law of the member states. European law also binds the courts of the member states; in developing law further and in interpreting it, they have to take into account European law. This is an important aspect of ceding national sovereignty. The European Court of Justice with its 15 judges is the ultimate guardian of European law; it also understands itself as the promoter of European law.

Even the constitutions of member states are affected. Thus, Germany had to change its Constitution in order to allow female soldiers to use weapons in the army. Apparently, conflicts between the European Law and the national constitution, or between the European Court of Justice and the German Constitutional Court, cannot be ruled out. The German Constitutional Court has the role of examining the constitutionality of laws, having declared quite a few laws unconstitutional and forced Parliament to change existing laws substantially in the past. The Constitutional Court wants to retain the right to examine the constitutionality of European law as well. In that function, it may indeed clash with the European Court of Justice. So far,

the German Constitutional Court speaks of a relationship of cooperation with the European Court of Justice. It is quite possible that, in an atmosphere of cooperation, severe clashes can be prevented. After all, over time all agents will become accustomed to European law. A potential solution to major clashes between European law and the constitutional law of member states would be a competence court, which would decide on where the competence for decisions lies.

The Budget of the European Union

Besides establishing a system of institutional rules at the European level, the political will of Europe finds its expression in the budget. Actually, the EU budget is restricted to a limit of 1.27 percent of the GDP of all member states. EU expenditure amounted to €98.6 billion in 2002. Of this, 45.2 percent was spent on agricultural policy, and 34.5 percent on the structural and regional funds.

The budget of the European Union is financed by agricultural levies (1.3 percent),[13] import duties (8.3 percent), and contributions of the member states (72 percent)[14]. Contributions by member states consist partly of the value added tax resource (23.5 percent for 2002); 1 percent of the national revenues of the value added tax is transferred to the EU budget. The other EU revenue is the gross national income (GNI) (48.5 percent), calculated as a proportion of national GNIs. The GNI includes income earned abroad, whereas GDP denotes income produced in a country, irrespective of whether foreign-owned factors have to be paid. The intention is to shift EU

[13] There is also a fixed duty on sugar and glucose produced within the EU, transferred directly from the sugar manufacturers.

[14] The rest of revenue is miscalaneous income.

financing more toward the GNI resource in the future. The percentage of the value added tax has been reduced from 1.4 to 1.0 percent in 1999. The tax base of the value added tax to be taken into account is capped at 50 percent of GNI instead of 55 percent as previously. Therefore, contributions are de facto related to GNI. The EU has no right to tax or to incur debt.

Germany has been a net payer to the budget of the European Union. It contributed 22.8 percent of the EU budget in 2002 and received 15.8 percent. It was the largest contributor and the third largest recipient. Its net contribution was €5 billion, or 0.24 percent of its national income. This ís a relatively low figure. The transfer is more than compensated by the advantages that Germany enjoys from the European Union, especially having the common market as an export area for its industry. Italy pays nearly the same percentage of its national income, other countries even more (the Netherlands pays 0.5 percent, Sweden 0.3 percent). The main recipients were Spain (1.29 percent), Ireland (1.50 percent), Portugal (2.14 percent), and Greece (2.39 percent).

The Impact of the EU on the German Economy

The question of how European integration has impacted on the German economy is a contrafactual question; we simply do not know how Germany would have developed if the EU had not come into existence. There is no doubt that Germany's integration into Europe has brought economic benefits from trade and specialization. Moreover, it can be seen as a foundation on which German unification was achieved.

As described above, the process of ceding national sovereignty has gone a long way. Besides monetary policy, all policy areas essential to the single market—such as trade policy, competition policy, the control of state aid—have been shifted to the European level. Decisions at the European level have changed national policy considerably, for instance, through a set of EU directives, the new institutional arrangements for the former natural monopolies. Among these directives are those on public broadcasting (1989), telecommunications (1988, 1990, and 1995), the railroads (1991 and 1995), the postal service (1997), electricity (1997), and gas (1998). In air traffic, business licenses for airlines are granted under the same conditions in the European Union (1992), although grandfather slots at airports still are prevalent. Bilateral traffic agreements between individual EU members and non-EU countries are no longer permitted following a 2002 decision of the European Court of Justice. In the liberalized financial markets, the home rule is applied in banking (1989) and insurance (1992), according to which the home country where the bank or the insurer has its seat is responsible for supervision. This allows institutional competition. In consumer and environmental protection, standards were established including for bathing water (1976), drinking water quality (1980, 1998), and ambient air quality (1996) that have to be respected by all member states.

The legal framework of the EU dominates the national laws. All these developments have redefined the conditions under which German economic policy has to operate. The most obvious change is that policy instruments simply are no longer available to the German policy-maker; he has to utilize a different instrument set. In quite a few areas, decisions are no longer taken nationally. Germany and the other EU countries each have

just one vote by which to influence the outcome. At the same time, the European approach takes precedence over national findings. Moreover, the reaction of the European partners to the policy instruments chosen comes to play. Thus, some targets may get a different weighting when European conditions are taken into account.

The German public is not aware of the size of the institutional change that has occurred. For instance, according to a survey of Allensbach, only 42 percent of the German population knew about a proposal of the Convention for a European Constitution in December 2003 which the European Council failed to push through.[15] There is a gap between the power already vested in the European Union and the public perception of the EU's role. Again according to the Allensbach survey, only 21 percent of the population thinks that the EU has a large responsibility for European economic development in the future, against 74 percent who believe that the decisions of the German federal government are still of great relevance. This is not consistent with reality. Moreover, the national government is held politically liable, whereas the European level can act without being held responsible by the voters.

The Road to a European Constitution

With EU institutional setup dominating the German legal rules, the further development of European-level institutions will have a further influence on

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[15] See *Frankfurter Allgemeine Zeitung*, December 17, 2003.

Germany's economic future. In this context, a constitution for Europe is a major issue.[16]

The EU treaty is a multilateral arrangement by which sovereign member states give up some sovereignty in favor of joint decision-making at the European level. This treaty is not a constitution. If the EU had a constitution—assuming that it would be a democratic one—the fundamental decisions would be made not by the Council but by the sovereign, that is, by the people or by a parliament representing the people. It is fairly realistic to state that at this time in history the European Union lacks even one of the decisive elements of a constitution, i.e. the European people as a sovereign, since a European citizen with a clear identification to Europe does not (yet) exist. Nor, therefore, is the EU a state. Neither is it a confederation with an intra-state pattern of rules, or an association of completely sovereign nation states. European integration relies on the method of intergovernmental cooperation where most of the decisions are taken in the European Council, reaching agreements between the heads of state or the ministers of specific portfolios (Siebert 2002). It takes its democratic legitimacy from the inhabitants of the member states by having the decisions of the various bodies of the European Union coupled to the national parliaments, as the German Constitutional Court stated in a major decision in 1993, in which Germany's membership in the Monetary Union was called into question by the plaintiff.

The European Union has been empowered by the individual member states through a treaty that has developed in several stages, beginning with the Treaty of Rome (1956), and encompassing the Single Act (1981) and the

[16] Besides these constitutional questions, the EU also faces the problem of how it can move to a higher growth path (Sapir et al. 2003; Siebert 2001).

Treaties of Maastricht (1992), Amsterdam (1997), and Nice (2000). The EU has the power to establish primary and secondary laws. New laws can be enacted only in the context of the Treaty and according to the stipulations of the treaty. The Treaty can be changed only in the same way that it was originally concluded: namely by negotiation and ratification by the individual member states. Thus, the member states are the masters of the Treaty.

The enlarged European Union of 25 faces two basic issues, one practical and one fundamental; both are interrelated. From a practical point of view, the enlarged Union can no longer be governed by the existing procedure of intergovernmental decision-making. Given the requirement of unanimity in a wide area of decisions, including even such aspects as the regional and cohesion funds in the next round of funding which will start in 2007,[17] and the possibilities of a varying set of coalitions for a blocking minority when qualified majority applies, it is hard to see how decisions can be reached. The risk of an institutional deadlock is real, unless recourse is sought in a variable geometry with different speeds. The European Union's development nearly stalled in the 1970s and the first half of the 1980s because of the members' veto and the Luxembourg Compromise. Introduced in 1966, the compromise stipulated that member states could claim a vital national interest so that the qualified majority rule was then not applied. Thus, members were able effectively to block unwelcome decisions. From a fundamental point of view, the EU has a democratic deficit. Many decisions are taken at European level by the Commission and the Council that directly affect the lives of Europeans, and these Europeans have only a very indirect and remote means of expressing their preferences and influencing these decisions. They do not have the option to vote

someone out of government if they dislike a specific policy. After all, their national governments will put the blame on other countries if the public does not accept decisions. Thus, the argument of the German Constitutional Court that the EU takes its democratic legitimacy from the people of the member states by having the decisions of the bodies of the European Union coupled to the national parliaments may be practical, but it is rather weak. Europe lacks the democratic responsibility of those who take decisions; it lacks democratic legitimacy.

The Constitution, agreed upon by the European Council at the Brussels meeting in June 2004, is an attempt to break that impasse. The Constitution still has to be ratified by the member states; several states including the United Kingdom will hold a referendum. If this process goes smoothly, the Constitution will become effective in 2007 at the earliest, except for provisions where specific dates have been set.

According to the new institutional arrangement, some decisions will be moved from unanimity to qualified majority. Thus, the powers of the EU are increased in areas such as asylum and immigration, energy, and space research, and to some extent in economic coordination, here with a newly created majority. The co-decision process, whereby the European Parliament has to agree on measures shaping policy, is to become the general rule between Parliament and Council. By and large however, not too many areas are designed to be moved to qualified majority. As a rule of thumb, about 65 percent of the decisions will be taken under qualified majority rule instead of 60 percent. The core decisions remain under the unanimity requirement. Member states retain the right to set national entry levels for third-country nationals. Social policy, taxation policy, foreign and security policy also require unanimity and thus remain national. This

means that the constitution represents only a small change toward a more intensified form of integration. In any case, moving unanimity items to a qualified majority will not reduce the democratic deficit, because the power to decide rests with the Council irrespective of the increased importance of the co-decision procedure.

The main point of contention why the first attempt to find a consensus in December 2003 failed was the new decision rule for qualified majority, a dual majority—i.e. to require the majority of the member states and the majority of the people, defined as 60 percent of the population. This 50-60 voting rule was to replace the voting procedure as defined by the Treaty of Nice, in which votes were assigned to the member states (see table 13.2). In this treaty, however, the votes were not really allocated proportionally to the population. The small and medium-sized countries (from Slovenia to Romania) have been designated a more than proportional share of the votes relative to the larger countries. And Spain and Poland had only marginally less votes than Germany with double the population size. (In the case of Germany, there was also a distortion relative to the three other large countries). Poland and Spain (under Aznar) insisted on the weighting as agreed upon in the Treaty of Nice. As a way out, qualified majority was redefined in the new Constitution with 55 percent of the member states comprising at least 15 of them and 65 percent of the population (Article I-24). Thus, it is made more difficult for larger countries to organize a majority. It also needs four members to block a majority. Moreover, a new type of qualified majority has been introduced: 72 percent of the members plus 65 percent of the population are needed, when the Council is not acting on a proposal form the Commission or from the Union Minister for

Foreign Affairs. This new majority also applies to enhanced cooperation or the eurozone where not all members are allowed to vote.

Other planned changes involve the organization of administrative decision making and attempt to enhance efficiency. A president of the European Council will be elected for 2.5 years. A post of foreign minister is to be established to represent the EU on external matters. The position of the president of the European Commission is strengthened. He lays down guidelines whithin which the Commission carries out its tasks. The members of the Commission shall resign if the president requests. From 2014, the Commission has to consist of only two-thirds of the member states, with rotation among the members.

Member countries may be given the right to opt out. This outing-out exception is a dangerous strategy for the Union because it can be used as a threat to get one's way and introduce a greater heterogeneity in institutional arrangements. The EU is a single undertaking, and the net benefits come in a package. Only in areas where the policy of two speeds applies should an opting out clause be granted.

For the European Central Bank, the Constitution contains some major changes. Whereas in contrast to the original plan the target of price stability is now included as one of the economic policy goals of the European Union (Article I-3 Sect.3), the ECB no longer is an institution sui generic, which it was according to its spezial mention in Article 8 in the Treaty of Amsterdam. It is now named an organ and is mentioned before the European Court of Auditors within the section ''Other Institutions and Bodies“. Usually, an organ has the duty of a loyal cooperation with the other organs of the union. This may sound relatively unimportant at first

glance, but it can be detrimental to the independence of the ECB in the longer run. Furthermore, the national central banks that form the European System of Central Banks (of which the ECB is a part) no longer have their independence guaranteed. Finally, but most important, the European Council may amend all or parts of the provisions of Title III of Part III which contains the institutional arrangement of the ECB. Whereas such a decision requires unanimity and consultation with the ECB, a new treaty is not necessary. Neither the national parliaments nor the people in a referendum will be asked to agree to a change in this important area. Together with the attempts to soften the stability pact, this is a rather worrisome development. The EU citizens and the financial markets may get the impression that politicians can now rearrange the contract of monetary union to strengthen the arm of politics and weaken the monetary authority. People in Germany may indeed feel that they have been misled, because monetary union was sold to them as something different. As a matter of fact, the concept of monetary union as a community of stability was the basis of the German law with respect to the entry into the monetary union, as the German Constitutional Court stated in its major decision of 1993 in which it asserted the constitutionality of giving up the Deutschmark. There is a declaration to prepare the conditions for fiscal stability in the good years of the business cycle, but this is not binding. The hand of the Commission in the deficit procedure has not been strengthened, it only can make recommendations to the Council, except for the proposal that an excessive deficit exists. This proposal can only be rejected with unanimity.

The Constitution lays out the basic goals of the European Union, putting some weight on social coherence and also social protection. The

Commission can start initiatives in social policy, including conditions of the labor market, health as well as industrial and research policy. It seems that to a certain extent Europe finds its identity in the idea of reducing differences in income and endowment with public goods. Although only a minor part of GDP is actually spent on these purposes, one can get the impression that the proposal can be interpreted in the sense of distributive federalism, where integration is seen as bringing people together via the vehicle of redistribution. In that sense, one can say that the Constitution is a welfare state and social democratic document, not a liberal one in the European sense. It does not cultivate the spirit of competitive federalism. Looking ahead, the interpretation of social cohesion and of social protection by the European Court of Justice Europe may rely more on the equity element than on the competition element in the future. In any case, the Constitution can be seen as moving the center of gravity away from the market mechanism.

The Constitution still will have to be ratified in the member states, in quite a few by a referendum. Blair's decision in April 2004 to hold a referendum on the constitution in the UK has added fresh uncertainty about whether the new framework will be accepted in the end. Belgium, the Czech Republic, Denmark, Ireland, Luxemburg, Poland, Portugal and Spain will hold a referendum as well. Until the uncertainty on the acceptance of the Constitution has been dissolved, the Treaty of Nice (with the weighting of votes) will remain the relevant legal setting. Then it is likely to become more difficult to make decisions in an enlarged European Union, because the veto power that each country holds as a result of the principle of unanimity will become a powerful hindrance.Looking into the very distant future, one can imagine how far away the European Union is from an

intensive form of integration if one envisions a scenario with an improved democratic legitimacy of the European level as follows. More decision power is given to the European Parliament. This implies that national parliaments must cede some of their competences.

The European Parliament itself can be conceived as a two-chamber system. Representatives for the first chamber would be elected, for instance by a majority rule for each election district; a second chamber would represent the member states. The electoral districts for the election of the members of the first chamber should be delineated such that each district represents a similar percentage of the population. The second chamber should represent the member states, ideally by electing the representatives of the member states directly (as in the US Senate). The Commission represents the European government. A constitution-like system of rules would define the competences of the European Parliament, its two chambers, the Commission, the member states, and the regional levels of member states.

Describing the future road in this way exposes all the problems that an enlarged Europe faces. From historical experience, we know that the principle of ‘‘no taxation without representation’’ is the basis of democracy. It seems realistic that the European population will not be prepared to cede national sovereignty, shifting the power to tax, the power to spend, and the power of the budget to the European level. This would mean that a European institution such as the European Parliament would be authorized to decide which type of tax to levy, the tax base, and the tax rate for the individual taxpayer; it would also be able to decide whether or not a tax collected in country A could be spent in Country B, either explicitly or implicitly.

The European Treaty allows member states to form special clubs that intensify their cooperation in specific areas such as border controls (Schengen countries) or monetary union. Countries may move at different speeds of integration. According to this approach, the dynamics of integration may be determined by a subset of the member countries, for instance by military cooperation. Different speeds and a variable geometry cannot, however, relate to the very essentials of a union. They must refer to additional steps that one may consider as desirable but not strictly necessary. Nor can a variable geometry solve the core issue of a democratic void; it is simply not conceivable that a European Club as a subset of member countries will develop a separated constitutional arrangement diverging from the other members, including for instance parliamentary voting and taxation. Moreover, a variable geometry would discriminate between members and entail the risk of splitting up the EU. Thus, the strategy of multiple speeds can be applied in the context of intergovernmental decision-making. It is less suitable for a more intense form of integration. Variable geometry or separate speeds can only be part of an intermediate step of integration.

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