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How can we understand the framework of economic governance in the EU?

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Abstract: Economic governance of the economic and monetary union amounts to a profound regime change that cannot be understood as a replication of a federal policy regime at the member state level. First of all, multi-level governance is distinctly different from what the economic theory of fiscal federalism presupposes. Moreover, it exhibits a peculiar institutionalisation of the four components that any macroeconomic policy regime of a mature political economy combines: monetary, fiscal and social policies, and the wage bargain. Lastly, the framework is based on conflicting assumptions about government's role: With respect to macroeconomic policymaking, governments should follow 'rules rather than discretion' that tie their hands; as regards structural reforms, it calls for considerable government activism. These features make the framework unique and untested, possibly inconsistent. They suggest to interpret EU economic governance as driven by domestic reform agendas, rather than economic integration as a vehicle for an 'ever closer political union'. Two pieces of evidence will be provided to support this interpretation: (i) the plethora of soft coordination processes; and (ii) the perception of the Lisbon Agenda and the actual record of reform.

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How can we understand the framework of economic governance in the EU?

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1 Introduction

Economic governance in the EU amounts to a profound regime change that cannot be understood as a replication of a federal policy regime at the member state level. First, multi-level governance in the economic and monetary union is distinctly different from what the economic theory of fiscal federalism presupposes in that it is characterised by overlapping policy functions and more than two intertwined government levels. Second, the monetary union exhibits a peculiar institutionalisation of the four components that a macroeconomic policy regime of a mature political economy combines: monetary, fiscal and social policies, and the wage bargain. Lastly, the framework is based on conflicting assumptions about government's role: With respect to macroeconomic policymaking, governments should follow "rules rather than discretion" (Kydland and Prescott 1977) that tie their hands; as regards structural reforms, however, it calls for considerable state autonomy in pushing through fundamental changes. These three features make the framework unique and untested, possibly inconsistent.

Yet, the political economy of reform can arguably explain what does not necessarily make sense in functionalist terms. This paper suggests that EU economic governance can be interpreted as driven by domestic reform agendas, rather than economic integration as a vehicle for an 'ever closer political union'. Two pieces of evidence will be provided to support this interpretation: (i) the plethora of soft coordination processes; and (ii) the perception of the Lisbon Agenda and the actual record of structural reform in the member states. Both phenomena are perceived as failures of the EU, particularly for the monetary union of twelve member states. The evidence suggests, however, that the Open Method and the Lisobn Agenda have not necessarily been ineffective in terms of policy outcome. Rather, they suit member state governments to enforce 'reform from above' and at the same time not to take sole responsibility for unpopular measures. The framework serves member states arguably better than EU bodies.

The following steps develop the argument: The next section outlines the three peculiar features of EU economic governance mentioned above, namely its political economy of fiscal federalism, the unique macroeconomic quartet and the conflicting demands on government that the Maastricht and the Lisbon Agenda entail. The third section outlines how the political economy of reform can explain these features and provides evidence for this interpretation. The last section concludes by pointing out that the framework may not be viable since, from the point of view of member states, it delivers well on the politics of reform but barely on integration and EU legitimacy.

2 The peculiar architecture of EU economic governance

By ‘economic governance’ I mean in this context the different policy ‘processes’ that rule the stabilisation and allocation of economic activity as well as the distribution of economic means in the European Union. These ‘processes’ (Cardiff for product and financial markets, Luxembourg for labour markets and Cologne for macroeconomic developments) are coordinated under the Broad Economic Policy Guidelines (BEPG) which add fiscal policy coordination. It would be more pertinent to call the latter ‘the Maastricht process of coordinated fiscal consolidation’. Last but not least, we must add monetary policy to this panoply of policy processes, except that the ‘Frankfurt process’ is not coordinated with the others but sets conditions for these other processes (Directorate General 2002: 4-6). The processes comprise ‘traditional’ hierarchical forms of governance, such as harmonised legislation to implement the Internal Market Strategy (Cardiff process), but also new, deliberative forms of governance, such as Open Method coordination of employment policies (Luxembourg process).

The distinction between the economic governance of the EU and EMU is blurred, above all because of the overarching function of the BEPG and because the stipulations of the Stability and Growth Pact (SGP), in particular the notorious 3% deficit criterion, also extend to outsiders of the monetary union. They are de jure exempt from hard sanctions under the Excessive Deficit Procedure. But then so are de facto EMU members as we learnt over recent months. What distinguishes the economic governance of EU and EMU are two elements of the macroeconomic quartet that do not apply to EMU outsiders – the common interest rate policy and the externalities of collective wage bargains. However, in both cases this may just be a matter of degree because central banks and wage bargaining parties may shadow interest rates and wage deals, respectively, in the Euro area.

2.1 Fiscal confederalism EU-style

In the light of fiscal federalism, the economic and monetary union of Western Europe is a close confederation (Gramlich and Wood 2000: 2). It is an alliance of states that does not share a budget but pays into a pre-defined fund to finance a central body, non-majoritarian agencies such as the Commission or the ECB concerned largely with administrative and regulatory functions. Before we analyse this fiscal confederation in the light of theory, a cursory look at indicators of tangible fiscal decentralisation illustrates how devolved a political economy the EU is:

- The share of spending at the EU level relative to spending at the member state level is extremely low. While in OECD countries, roughly one third (32% on average, between 5% in Greece and 58% in Denmark) was spent at the sub-national level in 2001. The analogous figure for the EU would be more than 95%, taking member states as the sub-national level and assuming an average share of public expenditure around 35% of GDP while the EU budget has a little above 1% of GDP (Joumard and

Kongsrud 2003: table 1).

- Correspondingly large compared to the central EU level is the share of member states, the 'sub-federal' units, in government revenues in general and taxation in particular as well as their discretion to set tax rates. In OECD countries, the shares of sub-national units in government revenues was 22% and in taxation 18% in 2001; the discretion to set tax rates at the sub-national level was between 100% in the Netherlands and the UK and 3% in Norway (Joumard and Kongsrud 2003: tables 1 and 2).[1] In the EU, the share of member states is higher, namely 100%, since the EU level has no own source of revenue, getting all fiscal means from the sub-federal units. This also means that the member states discretion to tax is 100%, the EU level only has a say in setting minimum standards for indirect taxes such as 15% for VAT.
- The share of member states in public employment approaches 100% since the EU's bureaucracy of 25,000 employees, the majority of which work as translators, is comparable to 'the number of staff employed by a typical medium-sized city council in Europe", as the EU's offical website puts it pertinently.[2] In comparison, the public employment share of sub-national units in OECD countries was 57% in 2001 (Joumard and Kongsrud 2003: table 1).

The public finance theory of fiscal federalism (Musgrave 1959, Oates 1972) tells us just how peculiar the EU's fiscal confederation is.[3] It is concerned with the question how the economic policy functions of stabilisation, redistribution and Pareto-superior allocation should be assigned optimally in a decentralised government setting (Buti and Nava 2003: 3-4). This is obviously a normative question that does not ask whether fiscal federations actually follow the textbook but rather predicts that it is costly not to do so. Its prescriptions, as well as how they are observed or ignored in practice, can be summarised as follows:

Stabilisation should be exercised at the central level of governance so as to pool as many risks as possible that occur at the lower levels, such as shocks to regional income and asynchronous regional business cycles. A sizeable central budget as well as central debt policy can even insure risks to current aggregate income by including future generations in the insurance pool (Barbie et al 2001). As already mentioned, monetary policy is the only policy in EMU that can pool risks to income generation in its member 'regions' as well as dampen aggregate volatility, for instance by targeting the yield curve of short, medium and long-term debt instruments. But the ECB mandate prioritizes price

[1] The lower share in (general and tax) revenues compared to the share in expenditures is in line with what the Musgravian textbook theory of fiscal federalism suggests while the power to tax is more devolved than economic theory leads one to expect (see below).

[2] At URL: http://www.europa.eu.int/institutions/comm/index_en.htm

[3] Note that this theory is not beyond criticism; in fact the 'anomalies' of the EU may teach us that the theory is lacking a political economy dimension which could explain that other federations, such as Germany or the US, are not very well described by that theory either (cf. Gramlich and Wood 2000). I will take this up in joint work with Deborah Mabbett (Birkbeck). – See also the seminal paper by Scharpf (1988) and more recently Boerzel and Hosli (2003) for similar attempts by political scientists, using comparative federalism to highlight the peculiarities of the EU.

stabilisation which does not always concur with needs of employment stabilisation. And monetary policy alone is likely to be short of instruments if goals are multiple.

Redistribution should be devolved in provision so as to cater to the specific needs and abilities of beneficiaries but centrally regulated and financed in order to avoid 'a race to the bottom' of welfare standards. The EU budget spends roughly 70 percent on redistributive policies. It is a matter of debate how much of this central provision is justified by compensating sections of the population that may be directly disadvantaged by European economic integration, such as farmers in peripheral areas or workers in declining industries. To me, it seems more plausible to understand this compensation as a welcome secondary effect of the primary purpose, in particular of structural and cohesion funds, to hand out side-payments for further integration and to engage in some fiscal equalisation as regards the net contributions to the EU budget (Allen 2000: 247-248; Joumard and Kongsrud 2003: par.62, fn.47). The financing of these redistributive schemes occurs, in line with theory, at the central level since it is the Commission that administers the funding of the CAP and structural development programmes. However, the financing of redistribution at the EU level which amounts to roughly 0.8 percent of EU GDP is miniscule in comparison with what the member states finance. In 2001, general government in the EU-15 (the Eurozone) raised on average 27% (26%) of national GDP in redistributive taxes and 13% (15%) in social insurance contributions, so overall receipts from taxes and SIC were around (above) 40% of the average member state's GDP.[4]

Policies to improve the *allocation of resources* should be devolved to the level where the positive externalities that public goods represent can be enjoyed by all potential users. Thus, a public park should be decided upon and financed by the local population that will be its permanent and most frequent visitors. Yet, assigning the responsibility to one government level so as to internalise these positive externalities is usually a difficult task because political and administrative boundaries do not overlap with the economic boundaries of such effects. Fiscal federalism can justify multi-level governance on efficiency grounds, such as the co-financing of the transport infrastructure. A good share of EU structural funding can thus be rationalised by the fact that the internal market becomes more efficient if all regions are well-connected in terms of transport. The same holds for the extensive regulatory activity of the EU; up to a point, common product and process standards allow to internalise spillovers and reap economies of scale.

The theory of fiscal federalism is government-centred and therefore does not cover the wage bargain between social partners. But if it were subsumed under the *stabilisation function*, the theory tells us that it should be centralised. The seminal paper by Calmfors and Driffill (1988) on the desirable degree of wage bargain coordination would support this on efficiency grounds (lowest in terms of an economic misery index). However, complete decentralisation may be equivalent on grounds of efficiency, if not on grounds of stability.

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[4] Source: Eurostat, Economic and financial indicators.

As this outline indicates, the most obvious deviation between the governance architecture of EMU and what functional public finance prescribes appears to be in the realm of stabilisation. This has partly to do with the EU's small contribution to fiscal redistribution in member states.[5] The bulk of stabilisation is 'automatic', delivered by redistributive taxes (that go down in a recession and up in a boom) and, to a much lesser extent, transfers such as unemployment benefits (van den Noord 2000, Mabbett and Schelkle 2005: 14). It is also noteworthy that the 'regulatory state' (cf. Majone 1996) of the EU is in line with textbook public finance if we see regulation mainly as providing a public good that improves allocation.

In a more fundamental institutional sense, however, economic governance in the EU as a whole and in EMU as its most fully developed part does not follow the functionalist script. This script assumes that the levels of central and local government with executive competencies are clearly separated, these government functions neatly differentiated, and the set of policies to fulfil them given. Multi-level governance in the EU violates each one of these assumptions:

- It is characterised by more than two intertwined government levels. This is very obvious in structural funding with its partnership principle that stipulates that not only national, regional and local government levels must be involved in drawing up development programmes but also social partners and other interested parties. Conspicuous sharing of functions between governance levels is also observable in the soft methods of coordination as regards employment or inclusion policies, or in the supposedly hard method of SGP coordination with the stipulation of national stability pacts.
- Policy functions are overlapping. Again, structural funding is a good example. While the overt purpose of structural including cohesion funds is to improve the allocation of resources in regions so that incomes generated from their use converge towards the EU average, this is achieved by redistributing from richer to poorer regions.[6] If structural funds are seen as fiscal equalisation schemes, they even have a minor stabilisation function (Joumard and Kongsrud 2003: par 67). More generally, re-regulating Europe, as in the Internal Market Strategy, covers all three fiscal functions. It is conspicuously about improving the allocation of resources in the economic space of the EU by creating a level playing field and transparency in competition. Yet, regulation is also inadvertently redistribution in that it defines and assigns property rights, a conceptualization that may be more pertinent for the political economy of regulation. Finally, some policymakers claim that it is a form of Non-Keynesian stabilisation by changing the adjustment capacity and pattern of the regional

[5] Cf. Boerzel and Hoesli (2003) for the problems of output legitimacy that these 'anomalies' create.
[6] The causality in the case of the CAP is the opposite, it was set up as redistribution from rich urban regions to poor rural areas, but its negative allocative effects (overproduction, overexploitation of resources etc) have become ever more noticeable. Moreover, the CAP's redistributive effects have turned out to be highly regressive, benefiting small farmers least, and are actually perverse if we take farmers from poor non-EU countries into account.

economies which substitutes for macroeconomic stabilisation (Buti and van den Noord 2003).

- These overlapping policy functions are shifting in their content. The Lisbon Agenda is an obvious example for that. In its beginning it was meant to contribute to the modernisation of social policies, ie. to the reform of redistribution, in member states. The emphasis has now shifted to improving allocation, namely creating 'jobs, jobs, jobs' (Kok et al 2003) so as to raise the use of underemployed resources as the Barroso Commission proposed in its mid-term review (CEC 2005a). Labour market reforms and fiscal consolidation are seen as not only underpinning but even substituting for stabilisation by improving microeconomic flexibility (Carone and Salonäki 2001, Buti and van den Noord 2003). All this implies a semantic and perhaps practical change of what has been traditionally understood to be the content of redistribution and stabilisation and is now meant to become primarily allocation.

In section 3, these features will be explained by the political economy of reform. Member state governments use EU policy coordination as a lever for domestic reforms and thus assign competencies for policies to fora at the European level so as to induce policy change, rather than protect national policies (Schelkle 2005b). This view is gaining ground and in itself not particularly original (eg. Pochet in Zeitlin and Pochet 2005: 61, Visser 2005). But what, to the best of my knowledge, has not been shown so far is, first, that the 'anomalies' of economic governance can be explained in that way and, secondly, that this makes for a framework that serves various national reform agendas but may not be viable for the EU in the medium to long-term.

2.2 The macroeconomic quartet in EMU

The macroeconomic quartet of monetary, fiscal, social policies and collective wage bargains (or incomes policy) is the major determinant of the income and price dynamic in mature economies. Why a quartet? Mainstream economists would only consider monetary and fiscal policy as instruments of macroeconomic stabilisation, and even Keynesian economists would only add the wage bargain or incomes policy to it (e.g. Allsopp 2005; Hein and Truger 2005). Yet, the modern welfare state has been constitutive for macroeconomic stability ever since the New Deal (Moss 2002: ch.7). The EU concedes or implies that now by 'streamlining' coordination under the BEPG with the Employment Strategy (CEC 2002). What is the economic rationale for this? To start with the conventional assignments:

Monetary policy is, at its most basic, interest rate policy to stabilise the price level as well as the exchange rate. With this one interest rate instrument, monetary policy also affects firms' demand for investment goods and households' demand for durable consumer goods or housing property. This effect on aggregate demand and thus on employment may be either too much or too little to stabilise prices. Thus, a second instrument, *fiscal policy*, is needed to get the right policy mix that targets both price stability and employment. But apart from hitting two goals with its one instrument, monetary policy has another deficiency, namely that it may be effective in combatting inflation but close to impotent in combatting deflation. This is because nominal interest rates can at most be lowered to zero percent which, at falling prices, still implies a positive real interest rate that may be too high for firms to resume investment. It is *collective wage bargains* that provide safeguards against deflationary pressures by setting a reservation wage that anchors the price level. Where collective wage bargains are missing or cover the economy very selectively, like in the US or the UK, a statutory minimum wage fulfils this function of setting a deflation barrier through the reservation wage.[7] Moreover, collective wage bargains – the main ingredient of what is called *incomes policy* if government takes the lead in a formal political exchange with the social partners – may also spare the central bank to use its blunt interest rate instrument by agreeing on non-inflationary nominal wage increases, ie. increases that do not exceed the rise in labour productivity. Finally, *social policy* is a macroeconomic stabiliser in two ways: first, unemployment benefits or social assistance support collective wage arrangements in their role as barriers to deflation. In a situation of high or rising unemployment, collective agreements or statutory minimum wages will be eroded by wage dumping if there is no alternative to market income available. Second, social policy supports the demand management through fiscal and monetary policy. Income taxes and unemployment benefits are built-in stabilisers that do not suffer from the decision and implementation lags of discretionary fiscal programmes and they are able to give demand management the desired redistributive impact, both to make stabilisation fair and more effective.

This outline of what role the different members of the macroeconomic quartet play indicates just how peculiar the EMU quartet is. (1) It has a full-fledged, unified monetary policy but neither the aggregate fiscal stance nor the collective wage bargains are coordinated with monetary policy; and because reservation wages in member states are just too different, social policy cannot prevent deflationary wage dumping in high wage economies (Kumar et al 2003). (2) The budget balance for EMU as a whole is the result of member states' budget balances and as such not formally coordinated. The EU budget is too small and must be balanced annually and therefore cannot play a stabilising function of adding to or subtracting from effective aggregate demand (Buti and Nava 2003). (3) The wage bargain is at best weakly coordinated in that some unions try, or are obliged by law as in Belgium, to shadow German wage developments (Hancké and Soskice 2003). But they seem not to have succeeded, nominal wages and unit labour costs have driven apart since the onset of monetary union, with German wage costs decreasing faster than others (charts 1a and b in the Appendix; Janssen and Mermet 2003: 685). (4) EMU hardly disposes of redistributive social policies that vary with the business cycle or cushion shocks to the monetary union. Structural funds are not designed to stabilise fluctuations of market income; the Common Agricultural Policy did and does

[7] The reservation wage sets a floor for decreases in the price level since commodity prices result from a mark-up on wage costs,. See Dullien (2004: ch.2) for a review of the theoretical and empirical literature on wage bargaining coordination and its interaction with central banking.

that to some extent but for only a small proportion of the working population in EMU and to a diminishing degree with the shift from price guarantees to direct income support.

The peculiarity of European economic governance does not stop here. It becomes even more obvious if we look at the interaction of these policies. This interaction determines the policy mix as well as the transmission of policy signals. In EMU, the macroeconomic quartet rests on the one dominant voice of the European Central Bank (ECB) setting the tone. There is only the weak instrument of the BEPG and, even weaker, that of the Macroeconomic Dialogue, to ensure that the other policies in the quartet respond consistently to the monetary signals.[8] The macroeconomic issues that this lack of concertation raises are two-fold: first, can the policy mix ever be consistent under these circumstances; and, second, can the transmission of policies to private sector activity follow a reliable and predictable pattern?

- Monetary and fiscal policy together determine the policy mix. In a recession, both interest rates should decrease or the currency weaken while fiscal policy should stimulate, be it by a lower surplus or a higher temporary ('cyclical') deficit. Charts 2 and table 1 in the Appendix provide information on the policy mix and the cyclical performance of big EMU members (that presumably are the target of monetary policy) from the mid-1990s onwards. Perhaps surprisingly, the policy mix has not been inconsistent, yet not forward-looking and stabilising either: while the aggregate fiscal stance became more expansionary (the overall deficit was rising) in 2000-01, monetary policy was easing in 2002. Employment growth, which was reasonably good in the second half of the 1990s, was slowing down sharply in 2001 and has remained lacklustre ever since (Directorate General 2005: 10-11). The easing of monetary policy subsequent to the overall fiscal stance could be interpreted as the ECB following fiscal policy. The unfolding of events, however, makes it more plausible to interpret this as the attempt of the ECB to discipline the softening of the fiscal stance when the Euro was finally introduced, yet the world recession unfolding and worsening in 2001 made monetary policy eventually ease its stance.
- The transmission of policies to private sector activity depends heavily on institutional features of financial, commodity and labour markets. For EMU, the monetary policy transmission channels are of particular interest since central bank policy is the only union-wide macropolicy. A number of studies has tried to identify the pattern and speed with which interest rate changes make themselves felt in the 'real' economy of the member states and how this transmission has evolved over time.[9] Although it is still too early to be sure, the good news is that asymmetries among the existing EMU members are not very high and they tend to become less over time. Moreover, the response to central bank signals seems to become stronger, if not faster. However, it is also clear that real interest rates, short- and long-term, vary widely even among the five big EMU members (Charts 3 in the Appendix). They are not closer together than

[8] See the contributions of Koll, Janssen and Watt in Hein et al (2005).
[9] Angeloni and Ehrmann (2003) provide results in light of other studies. See also Andersen (2004) on heterogeneous wage formation under a common monetary policy.

they have been in the mid-1990s. A noticeable change is that Germany and the Netherlands then had the lowest relative to the other big members and now have the highest real interest rates.[10]

With regard to these two concerns of any macroeconomic policy regime, EMU has not performed too badly. But macropolicy has probably not contributed to employment growth either. It is remarkable that DG Ecfin has just published an extensive study on the phenomenon of jobless growth in the EU, taking up a discussion in the US. The study concludes that 'structural reforms of product and labour markets, together with wage moderation, began to pay off in terms of employment' by the second half of the 1990s (Directorate General 2005: 10), yet this seems to have led to productivity driven, 'jobless growth' only in 2001-2004. This timing suggests that it was the uncertainty related to the macroeconomic regime, as reform activism has become more intense if not more intense (at least until 2002 for which there is data).

Moreover, the dismal science suggests we should add another note of caution. The weak mechanisms that make for a consistent policy mix and reliable monetary transmission have not really been tested so far.[11] This test would be a deflation for which the anti-inflation framework of EMU is ill-prepared, as outlined above. Japan's deflation since the early 1990s has shown that deflation may return and bring one of the most successful post-war economies on its knees (cf. Krugman 1998). It was triggered by a severe recession that made a bubble in the real estate market burst and was then sustained by policy mistakes as well as a large unregulated labour market. Contrary to popular belief, the Japanese 'lifelong job security system' accounted for only about 20 percent of all workers at the beginning of the 1990s and has shrunk since (Sassen 1991: 288; cf. ILO 2004: ch.5). In EMU, that trigger could be prolonged depression of economic activity in one or more large economies, as the IMF warned with respect to Germany.[12] Thus, it is plausible to argue that what has prevented a deflationary spiral to unfold is Germany's counter-cyclical violation of the Stability Pact rule as well as robust labour market regulations and a still generous welfare state. This is obviously ironic. EMU may have been spared a severe economic crisis by all those policies and institutions that Germany has promised – and as we will see below, started -- to change in order to meet the barrage of criticism they have attracted over the years.

[10] However, real interest rates are not high in absolute terms. Given the opposite impression in the public debate, it is worth mentioning that chart 2a shows EMU outsiders experiencing even a tighter monetary policy than the Eurozone, ie. EMU kept so far its promise of relatively lower interest rates on average.

[11] Cf. de Grauwe and Senegas (2003) on the asymmetry and uncertainty of monetary transmission and Wyplosz (1999) for an early warning, accessible to non-economists, regarding the unresolved question of what determines the policy mix.

[12] Kumar et al (2003: Box 2). See also Holden (2004) on the particular adjustment problems of wage formation under low inflation.

2.3 The simultaneous agenda of the EU and its demands on government

Ever since the late 1990s, culminating in the Amsterdam Treaty and the Lisbon summit conclusions, EU economic governance has pursued the dual agenda of structural reform and fiscal consolidation. The following is meant to highlight a political economic aspect of this simultaneous agenda, namely the rather different demands on government that it entails. It will not be discussed whether and why the Lisbon Strategy or the SGP have been less successful than its proponents hoped nor whether they are supportive of each other.[13]

The political economy literature that theoretically endorses the simultaneous agenda of the EU, maintaining that joining a stability-oriented monetary union provides the political room for manoeuvre to proceed with labour market reforms.[14] Once public expenditures are constrained by a fiscal rule such as the Stability Pact, the labour market parties (unions in particular) must realise that employment protection and wage bargains have an immediate impact on employment that will be borne by private sector employers or union members. The underlying 'back against the wall' hypothesis assumes that fiscal crises make reform easier because they raise awareness of the costs of the status quo and thus weaken the opposition to reform (Rodrik 1996: 26-29; IMF 2004a: 113-115). Obviously, it must also assume that this disciplining effect impresses all potential opponents alike, ie. it must not be impaired by the heterogeneity of opposition and consequent free riding of more protected sectors. Interestingly, a high rather than a low degree of wage bargain coordination would be conducive to exercising general discipline insofar it is more likely to solve the logic of collective action problem.

This strand of the literature is built on a model of government which is prone to moral hazard and opportunism and thus needs the countervailing force of external pressure to get rid of its deficit bias that nurtures inflation and unemployment. It takes off from Kydland and Prescott (1977) that conceptualized policy making as suffering from a credibility or time-consistency problem. Governments have objective functions characteristically different from those of the median voter. This difference in preferences is caused by special interests that capture government so that the latter's objective function has different weights for goals such as low inflation or high employment compared to the electorate at large.[15] External pressure is a counterweight to their grip on the government.

A conceptual and practical problem with this strand of the literature emerges if we take a closer look at the contents of structural reforms. Much of the welfare reform and labour market flexibilisation agenda advocates reneging on commitments since entitlements to

[13] Attempts can be found in Schelkle (2005a) and Mabbett and Schelkle (2005), respectively. The following draws heavily on the literature review of the latter working paper.
[14] Cf. Bean (1998) and for more cautious assessments Sibert and Sutherland (2000) and Calmfors (2001).
[15] Another explanation that can be found in the literature is caused by a fundamental institutional 'problem' of democracy, namely policymakers' myopia due to uncertainty about re-election which makes for a higher discount rate than the median voter has.

the existing amount of unemployment benefits or pensions are called into question.[16] Thus, the EU's dual agenda requires a government behaviour with respect to structural reforms, namely a time inconsistent breaking of promises on social security, that it tries to prevent with respect to public finances by imposing a fiscal rule as enshrined in the Pact. The EU intervention signals in each case that the domestic government cannot be trusted but also that the government is impaired in its effectiveness by complying with the EU mandate.

Another strand of the political economy literature sees tensions between an ambitious agenda of structural reform and fiscal consolidation. It is based on what might be called a 'need for bribes' hypothesis, suggesting that fiscal room for manoeuvre is required to get reforms going by compensating potential or actual losers from reforms. A rise in the budget deficit may also be necessary to bear the upfront costs of reforms such as implementing more effective employment agencies in preparation for welfare-to-work measures. Interestingly, the IMF sides with the 'need for bribes' hypothesis, based on comparative empirical studies of reform processes, and recommends accepting a temporary worsening of public finances to make reforms happen (IMF 2004a: 115-116, 132; IMF 2004b: 48, 58).

This strand of the literature is interested in what determines reform dynamics, stimulated by the wealth of experience with major reform processes in countries at all levels of political and economic development (Rodrik 1996). Partly for reasons of econometric methodology, policymaking is conceptualised as the outcome of a government optimising an objective function that is representative of an electoral platform or of the median voter's preferences. But the government is also constrained by economic and political factors that are not directly under its control (IMF 2004a: 109). Without these constraints that determine whether structural reforms get sufficient political support to be carried out, a government would steadily implement the measures that make the political economy move on the reform path towards the desired state of labour, product and financial markets or the tax system.

This conceptualization of government implies that governments are typically not fully in control of the policy agenda. But nor are they catering to special interests only. Majorities have to be found and strategic alliances built because there is not one best policy or reform for all.[17] European integration should therefore not tie but strengthen government's hands, for instance by diverting special interests to the EU level or by providing more effective means of stabilisation.[18] Pursuing the EU's simultaneous

[16] We are grateful to Elena Bechberger (LSE) for alerting us to this. Her thesis will explore welfare state reforms from this angle in France and Germany.

[17] Interestingly, "almost all the determinants of reforms play a significantly different role depending on EU membership". (IMF 2004b: 57) This means that findings on the political economy of reform which are often based on studies of the US, typically do not hold for EU member states. More specifically, EU membership seems to have a positive impact on labour market reforms but a negative on product market reforms (IMF 2004b: table 1).

[18] As the monetary union arguably did for weak currency areas, such as Italy, which could pursue an autonomous monetary policy only at the risk of an imminent currency attack. -- Macroeconomists have

agenda is very demanding of governments in modern democracies and mature welfare states.

This implies in turn, that the simultaneous agenda is based on the ‘back against the wall’ view. If this explanation were correct, the national electorates in the EU would have to trust the civil service in Brussels more than their domestic politicians and that the dual agenda is in the interest of the tacit majority. Voters must, in principle, be content with the fact that the government’s hands are tied with respect to fiscal policy by an international treaty while the executive forcefully implements structural reforms against the vocal opposition from protected or subsidized labour market parties and welfare associations. The EU should be seen as technically competent and more publicly spirited by comparison. The evidence on this is mixed if we believe the Eurobarometer survey (Eurobarometer 2005: 22): In the EU-25, the electorate seems to ‘trust’ the EU more (50% ‘tend to trust’) than national political institutions such as the parliament (38%), government (34%) or political parties (17%). But respondents also seem to trust the UN (54%) more than the EU which suggests that respondents ‘tend to trust’ bodies that have little direct impact on their lifes. Similarly ambiguous are results on the question: “For each of the following issues in your country, do you think the European Union plays a positive role, a negative role or neither […]?”(Eurobarometer 2005: 26) More see a positive than a negative role of the EU for the economic situation of the country (39% positive, 31% negative). However, the EU’s role is seen less favourably with respect to any specific economic issue such as fighting unemployment (25% positive, 37% negative), rising prices/inflation (21% positive, 49% negative), taxation (17% positive, 41% negative) or pensions (15% positive, 33% negative). Again, this is compatible with suspecting that the EU would lose some trust among voters as soon as the EU’s role in economic and social policymaking would become more conspicuous and tangible. This is hardly comforting for the EU’s simultaneous agenda.

3 The political economy of reform in EU economic governance

The preceding analysis can be accused of lamenting about the obvious fact that the EU is not a federal nation-state or a textbook economic regime, respectively, which does not fit our received theories. This normative stance, prevalent among mainstream economists, foregoes the chance to enrich our understanding of political economies by making sense of the admittedly strange political-economic system that the EU represents.[19] The approach to the political economy of reform that I propose in the following extends and generalises the path-breaking insight of Pierson (1994) that welfare state retrenchment has a specific logic and deserves study in its own right. This seems to apply even more to far reaching reform processes, the main difference being that even the direction of change

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criticised the Stability Pact early on for constraining rather than empowering fiscal authorities to stabilise effectively (e.g. Buiter et al 1993, Goodhart and Smith 1993).

[19] This is in line with the approach taken by Hix (1999) and Verdun (2005), namely to analyze the EU as an extreme case that can inform disciplinary, in his case political science, studies. It is critical of an area studies approach that treats the EU as an idiosyncratic case for which we need ‘special’ theories.

– retrenchment or partial expansion -- may be contested. Reform is inadvertently policy-making under uncertainty (Lohmann 2000) and different types of uncertainty create different political constraints (Roland 2000: ch.2). What may look irrational or inconsistent in the light of theories for ‘business as usual’, can make sense if seen as devices to deal with political constraints of economic reform processes or as tools to contain uncertainty in an endogenously changing environment.

I will argue, in particular, that this makes the functional theory of fiscal federalism inapplicable to the EU, both because it presupposes too much political integration and because it presupposes another finalité of integration. The first sub-section highlights phenomena and political strategies that become particularly noteworthy, once we regard domestic reform processes rather than deeper European integration as the driving force behind policy coordination. The second sub-section outlines a view of federalism that sees devolved policy-making as a way of fostering reforms in member states, namely ‘laboratory federalism’ (Oates 1999: 1131-1132). The last sub-section will provide some qualitative evidence for this being a more pertinent explanation for the set-up of economic governance in the EU than either functional public finance or the political economy of dynamically consistent (‘credible’) policy-making.

3.1 The logic of reform processes

A political economy of reform approach turns a major assumption of functionalist or realist views of European integration on its head: Change, not preservation of national policies is the very goal of integration.[20] Yet, political economy and institutionalism teach that all attempts at reform have to be achieved against strong forces in favour of the status quo, be it due to active resistance by potential losers of change or be it because established routines and entrenched practices create inertia. The burden of proof then is with those who claim that reform and change are actually happening. A theoretically consistent explanation would find that institutions can only be upset by other institutions, ie. the building of new institutions has undermined or at least considerably modified the functioning of the old.

The new mainstream political economy of transition is based on this institutionalist insight (eg. Rodrik 1996, Stiglitz 1999, Roland 2000): large-scale systemic change does not succeed by destroying the old infrastructure and then rebuilding a new one from scratch, but by taking the legacy into account and superseding it with new institutions until old practices and routines lose their grip. The combination of old and new is bound to lead to surprises. A rational choice approach will take them as politically motivated aberrations from the original Pareto-superior design and tends to ignore legacies.[21] An

[20] Elsewhere, I have applied this approach to interpret the Open Methods of social policy coordination (cf. Schelkle 2005b) and the following draws on this article.

[21] See the pertinent quote in Stiglitz’ (1999: fn.12) critical account of the IMF approach at the time: “One colleague quipped: ‘The institutional blitzkrieg destroyed without replacing the old social norms -- removing the last restraints against society-threatening levels of corruption. This is like using a flame-thrower to burn off an old coat of housepaint, and then lamenting that you couldn't finish the new paint job

institutionalist explanation would try to take these unintended consequences of intentional institution building as indicators of functional incompatibilities that, as long as they prevail, feed political contests between conservative and reformist forces. It is in this sense that reform is bound to be 'policymaking under deep uncertainty' (Lohmann 2000) because even in cases where the blueprint for reform is clear, the world in which they are implemented is institutionally and politically not a blank slate, so the interaction of old and new as well as political contestation create indeterminacy.

Uncertainty is a relevant consideration as regards the feasible speed and scope of reform (Roland 2000: ch.2). Idiosyncratic uncertainty means that there is consensus about the overall benefit of a reform – the blueprint is clear -- but not about the identity of winners and losers. This creates an interim status quo bias if implemented gradually because losers of the first round will oppose further steps while the winners of later rounds do not make themselves heard yet. Swift and large-scale reform of the Big Bang variety is then the most promising strategy. Aggregate uncertainty, by contrast, may exist about bad or good realisations of the reform while the identity of winners and losers in each post-reform state of the world is known. Sequencing and gradual implementation may then overcome resistance because it reassures a potential majority of losers that adjustment of the blueprint or even return to the status quo ante is possible should the bad outcome be realised.

In EU integration, we have seen both types of reforms and we can infer from that what types of political constraints, created by uncertainty, policymakers have perceived and tackled. On the one hand, grand summits, such as the one that ratified the Maastricht Treaty, amount to a 'Big Bang' approach that can deal with idiosyncratic uncertainty. A consensus had formed among the elites that a stable common currency would yield predictable net gains for member states (McNamara 1998: ch.6). But there was uncertainty about which industrial sectors or sections of the economically active population would be permanent or temporary losers of this major change in economic policy regimes. The six months presidencies, on the other hand, typically engage in piece-meal evolution. Supposedly, they deal with aggregate uncertainty about the blueprint and its realisation even if each presidency starts with the ritual of launching a new initiative. Voters have become rather sceptical regarding the overall benefits of deeper political integration as represented by the constitutional process and about enlargement. Subsequent presidencies will therefore implement the steps that are deemed necessary for the functioning of the enlarged union cautiously and could explain why negotiations about future accessions may be an even more drawn-out process than previously.

How can this political of reform explanation, with its emphasis on the institution-building aspects of reform, deep uncertainty and the consequent necessity for blame management, account for the apparent anomalies or even inconsistencies of EU and EMU economic

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because the house burned down.'"

governance?

- The asymmetric functioning of the macroeconomic quartet, with its dominance of the central bank and virtually non-existing wage coordination, is not an anomaly but a desirable institutional setting if domestic reform was the overriding goal. The governments that signed the Maastricht Treaty did not want to preserve and replicate their domestic policy regimes but shake it up.[22] They had tried before to deal with persistent high unemployment, did not succeed and experienced that what had become the favourite culprits, corporatist arrangements or generous safety nets, proved quite resilient against attack. Thus, the Macroeconomic Dialogue was an afterthought, peripheral to the Maastricht framework, and it is therefore not surprising that in the recent debate about the reformulation of the Pact there was hardly any discussion about giving it a role similar to arrangements at the member state level. On the contrary, the 'New Social Pact' that some countries managed in the run-up to EMU, have tended to erode in the meantime (Hancké and Rhodes 2005); they have arguably been superseded by the new institutional setting of macropolicy-making in the monetary union. There are costs involved for this instrumentalisation of EU monetary integration, for instance a recessionary or even deflationary bias as the IMF noticed and the OECD recently suggested by urging the ECB to lower interest rates.
- Similarly, the demands on government implied by the EU's simultaneous agenda of structural reform and fiscal consolidation makes are not necessarily contradictory if seen as governments' attempt at redefining their role. As indicated, EU governments have been seen as fairly powerless in the macromanagement of gainful full employment ever since the 1980s. It first resulted in accelerating inflation and then, after the Volcker shock of 1979 that marked the end of monetary accommodation to fiscal stimulation, in rising levels of either working poverty or unemployment, ie. a rising share of the population of working age (18-65) depending on transfers supplementary to or substituting for wages. It thus seemed opportune to delegate a major macroeconomic policy to a non-majoritarian agency, a central bank that mimicked the successful role model of the Bundesbank[23] and was to take care of inflation, relegating fiscal policy legitimately to staying within the constraint set by monetary policy, even against the policy advice of prominent macro-economists like Modigliani and Tobin (McNamara 1998: 151-158). Structural reforms such as privatizing parts of social security and public utilities can be seen as attempts at shifting risk – or 'responsibility' in the jargon of New Labour – back to firms and households, in particular those out of work.

[22] I do not know of a research project that has systematically looked at this but Martin and Ross (2004) comes close. See also Dyson and Featherstone (1999: 80 on France, 470 on Italy, 668-671 for British opposition to EMU).

[23] The success of the Bundesbank, however, was largely one in the catching up process of the '50s and '60s, when a relatively better performance as regards price stability combined with a fixed parity to the US dollar amounted to an enlightened Keynesian demand strategy: the real undervaluation of the DM that resulted from this policy made rising exports and a low interest rate a main stimulus of demand (Riese 1978). When the catching up came to an end, the Bundesbank managed to keep price stability but the employment performance got worse even before German unification and the run-up to EMU.

Finally, this political economy of reform perspective also suggests a different view of (con-)federalism than functional public finance holds in store. Since this is the core of what EU/EMU economic governance is about, it deserves a sub-section of its own.

3.2 Laboratory federalism with a weak centre

As outlined above, the EU overall and EMU specifically are not fiscal federations. This is to say that in public finance terms, there is no full-fledged governance level at the EU level for the simple reason that it has a negligible budget that does not interact with the budgets of the member states (Buti and Nava 2003: 5). The EU budget resembles that for an agent with well-defined tasks being financially closely monitored by the principal.

And yet, neither the ECB nor the European Commission are merely agents of the member states as intergovernmentalism would have it. Given her degree of independence, the ECB is rather a trustee of member states' monetary policy who can no longer be monitored by them (Majone 2001: 105, 113). Moreover, the Council regularly installs the Commission as a quasi-principal of member states, or more precisely as a *delegated monitor* of legislative harmonisation and policy coordination. This holds generally with respect to the Commission's role as a 'guardian of the Treaty', ie. EU legislation initiated by the Commission but implemented by the members. But this also holds more specifically with respect to the Lisbon Strategy or the concertation of fiscal consolidation and other policies under the BEPG. In each case, it is the member states that are the agents, supposed to implement and exercise Commission directives and guidelines.

The time-honoured notion of laboratory federalism (Oates 1999: 1131) can grasp this peculiar form of multi-level governance where the centre is primarily the agenda-setter for policy and law making, yet possibly a mere agent if looked at in fiscal terms. The central idea is that reform and the dissemination of reform experiences at the member state level is a public good, ie. a positive externality in use, of which there is too little without a federal agency to provide it. Provision in this case can take various institutional forms, be it giving financial support to bear the upfront costs of reforms or organising a formal peer review.

Economic governance in the EU and in EMU as it stands can be seen as the institutionalisation of laboratory federalism with a fiscally weak central level.[24] Member states have created a central governance level that they can use as a leverage for their reform agendas at the domestic level. The reform agenda has been shifting and wide-ranging. First, the monetary union was meant to upset the corporatist embedding of labour markets. It now also encompasses the safety nets regarding non-employment, ie. social assistance and unemployment benefits, pensions and sickness pay. This central governance level does not have a budget to incentives reforms and the sharing of reforms at the member state level. Enabling the federal level to give fiscal incentives for reform would have potentially led to a uniform approach that governments are not ready to

[24] Sbragia (2004) stresses the singular weakness of the EU's centre.

embrace at this stage. And it would have undermined the idea of tying governments' hands, that is to use fiscal austerity as an instrument for a 'back against the wall'-strategy of reform.

While the evidence on whether this disciplinarian form of laboratory federalism has worked is mixed as will be outlined in the next sub-section, it is conceivable that a central level without financial but some regulatory leverage may avoid the notorious joint decision traps of federal systems. This is for the paradoxical reason that the EU can be given a standing licence to interfere and give policy advice exactly because the Commission is weak enough as regards implementation and not as purist in its policy advice as for instance the OECD or the IMF until recently. Members of the laboratory federation must not fear that the centre will be able to implement a controversial policy regardless of their opposition. The EU's laboratory federalism is therefore based on the ominous 'new', ie. non-hierarchical forms of governance like the OMC (cf. Héritier 2002, Zeitlin and Pochet 2005). They create fora for deliberation where attempts at strict enforcement would be counterproductive because there is consensus neither on what to enforce uniformly nor on how to do it.

This is not to endorse interpretations that associate open method coordination with participatory forms of policymaking, a postnational democracy in the making (Sabel and Zeitlin 2003; Mosher and Trubek 2003). A blame management and political economy of reform perspective suggests rather that participation will be highly selective with governments acting as observant gatekeepers. They are attempts at technocratic politics, yet this does not make them unaccountable and non-state actors may be able to use these new channels more extensively than the gatekeepers wish. One channel through which these new forms of governance may exert an effect, for instance undermine established practices or rules, is by creating peers in the sense of a selective audience, the critique or non-approval of which is to be avoided.[25] Regular reporting requirements regarding the performance against common indicators and benchmarks are political instruments to stir up administrations without inciting their outright resistance. Bureaucracies and regional or local policymakers can hardly refuse to be 'transparent' and to compare themselves. The various soft coordination mechanisms can be seen as institution building meant to challenge the entrenched institutionalisations of national welfare states.

The softness of the coordination mechanisms that extend notably not only to social policies but, after the reform of the SGP also to fiscal consolidation, make them ideal for blame management. If an administration fears to be embarrassed by the mandatory peer review, the most it can do is to fudge the account or take the line that the comparison is between apples and pears.[26] Yet, this does not mean that the exercise is without effect. At

[25] Lohmann (2003) has formulated an audience theory to explain how non-majoritarian institutions, like independent central banks, are held accountable which may apply to new forms of governance as well.

[26] The 2004 National Action Plan on Employment by the Italian government is a perfect example of such a strategy, yet it is so conspicuously evasive that it must invite criticism. It cannot even be properly quoted because it does not have a title page. Cf. http://europa.eu.int/comm/employment_social/employment_strategy/nap_2004/nap2004it_en.pdf

least, that particular administration has to engage in evading or justifying an assessment – and may be caught or prove to have good reason for defending itself, respectively. This is in the nature of reforms, ie. the uncertainty both as regards their substance and their effects which makes them legitimately vulnerable to challenge. The political leadership of that administration then has the choice to back the administration, at the risk of becoming vulnerable to attacks by the opposition, or to engage in conspicuous blame taking, thus strengthening the reformist forces within a bureaucracy. In other words, the status quo is questioned or becomes at least questionable.

How then does the earlier analysis of the monetary union's deficiencies seen as a fiscal federation link up with this interpretation as a laboratory federation? These deficiencies are costs of what a functionalist theory characterises as excessive devolution (Joumard and Kongsrud 2003: par. 30-33). They may include the underprovision of welfare benefits and redistributive services, inequity among regions, duplication of public services, or cost-shifting and free riding among lower-tier units. Yet, the interpretation as laboratory federalism suggests that these costs are not coincidental but the price policymakers in the EU are willing to pay.

3.3 Domestic reform rather than creating Social Europe: some evidence

The bottomline of the preceding sections is that looking at EU economic governance from the point of view of integration theory leads one to spot a number of anomalies and inconsistencies. Looking at it with a political economy of reform perspective in mind, one can see that these anomalies make sense although they come at a cost which would explain the EU's less than splendid appearance at present. In this sub-section, I will provide two pieces of qualitative evidence to back up the argument that it is uncertainty and blame management that can explain economic governance in the EU and EMU. The first is the plethora of soft coordination processes, in particular the transformation of a hard mechanism like the SGP into a soft one; the second piece of evidence concerns the discrepancy between perception and performance as regards Lisbon-type reforms in member states.

Open Method Coordination of policies has been called a 'Third Way' (eg. Linsenmann and Mayer 2004) of policy integration between harmonisation and mutual recognition. It is 'open' in terms of soft or non-hierarchical as a method with peer review as the main pressure, allowing for a variation of means to achieve common goals such as a reduction of child poverty or fiscal consolidation, and participatory in the sense of accessible to non-state actors such as poverty networks or the social partners. Originally defined with respect to the European Employment Strategy (EES), it is now widely applied to various core social policies such as inclusion, pensions and health[27], to environmental policy and to economic policy coordination (Hodson and Maher 2001). The BEPG existed under this name since 1993 to prepare member states for EMU and thus came into being before the

[27] For an up-to-date evaluation of the OMC of social policies with a number of country studies see the contributions in Zeitlin and Pochet (2005).

OMC was retrospectively applied to the EES at the Lisbon Council in 2000; they contain all the elements of an OMC: guidelines at the EU level about what to achieve, combined with timetables; common indicators or benchmarks for goal attainment; plans or programmes drawn up at the national level to translate the guidelines into practice; periodic monitoring and peer review, originally with the intention of identifying 'best practice'.

The overwhelming finding of empirical case studies is that the OMC on social policies has a discernible effect on redistribution in national welfare states only where governments want to reform in any case, it can act as a 'selective amplifier for national strategies of reform' (Visser 2005). To take the most recent in-depth studies in Zeitlin and Pochet (2005): Jacobsson on Sweden and Denmark shows that governments were above all concerned with exercising their gate-keeping role and resisting *too much* pressure for reform from the OMC (ibid., 164); Ferrera and Sacchi on Italy illustrate that the effectiveness of the Method depends largely on the reform activism of changing administrations which is miniscule under the Berlusconi government (ibid., 152, 159); Visser on the Netherlands describes yet another aspect of the 'amplification effect', namely that the Dutch government keen on Social Europe used the peer review mainly 'to sell the Dutch success story' (ibid., 193); Erhel, Mandin and Palier on France describe a limited 'leverage' effect, ie. how reformist forces use the OMC as a political resource and that the European influence has a discernible impact if it leads to organisational changes such as the decentralisation of running employment agencies (ibid., 229, 237-238); Büchs and Friedrich on Germany show that the influence on the National Action Plans is largely confined to the various government levels but that foreign good practices have been used to argue the case for the recent Hartz reforms (ibid., 266); Armstrong on the UK suggests that the OMC made a difference in the sense that it created a channel for "'bottom-up' shifts in domestic institutional cultures and routines" (ibid., 298); O'Donnell and Moss on Ireland find only a secondary relevance of the OMC, compared to social partnership processes both nationally and related to structural funds (ibid., 327). In the concluding chapter, Zeitlin (in Zeitlin and Pochet 2005: 480) sums up these findings: "Probably the strongest and most effective mechanism of domestic influence identified by recent empirical research on the OMC is its strategic use by national and subnational actors as a resource for their own purpose".

The backward-looking, 'reporting' nature of National Action Plans (NAPs) is a recurrent theme of empirical case studies (eg. Rubery: 408 and Zeitlin: 461 in Zeitlin and Pochet 2005) but also of Commission documents (eg. Council 2005: 19). That is, the Plans are actually listing more what has been done in the past than what is in the offing for the foreseeable future. This makes obviously sense if governments want to avoid to stir up opposition, if only for the reason that such announcements in EU documents preempt parliamentary debate at home. Yet, there is ample evidence that governments do circumvent parliamentary scrutiny at home by giving national parliaments precious little time to debate the contents of the NAPs on employment or inclusion (Council 2005: 19). This suggests that it is less their concern about the problématique in democratic terms that a forward-looking NAP would entail – a fact that complaints in EU documents seem to ignore – but blame management. Reporting on past reforms flags up the achievements and allows to signal reform activism without being specific about the next moves.

Finally, the ambition to identify ‘best practices’ has not been successful as the Commission admits in the joint reports; the delegated monitor has in the meantime become more modest and tries to distil merely ‘good practices’ out of the NAPs (Council 2004: 41; Zeitlin in Zeitlin and Pochet 2005: 473). This again underlines the dominance of domestic settings and agendas in the European integration of redistributive social policies. The European level is allowed to interfere when reforms need to be portrayed as growth-enhancing, ie. stressing their role for allocation rather than redistribution. This is in line with the hypothesis that soft methods of integration work best or even that they are effective only where redistributive issues do not figure prominently.[28] But the political economy of reform perspective adds to this that to some extent it is itself a matter of reform politics to play up or down the redistributive character of measures planned and play down or up, respectively, its allocative implications (‘pro-growth’). It is part of reform politics to determine and possibly change the very perception of what a policy is about.

The recent reform of the SGP is in my view the clearest example for the interpretation that domestic reform rather than European integration is the substance of what economic governance is about. Initially, the Pact was rationalised on the grounds that unfettered fiscal policies would lead to increasing public debt, inflationary pressures and a rise in real interest rates. The 3%-deficit rule was thus a way to contain this dynamic and signal to wage bargainers that the government would not compensate wage bargains that lead to high unemployment. This rationale has in the meantime become less convincing, given that inflation and interest rates stayed low despite a rise in public debt and 5 out of 12 EMU members temporarily or actually in breach of the deficit criterion.

The next rationale for why the Pact has to be upheld in its original form was a variety of the ‘back against the wall’-hypothesis (Calmfors 2001, Buti and van den Noord 2003, Padoan and Rodrigues 2004). The conspicuous need for fiscal consolidation would, it was hoped, strengthen the political forces for structural reforms that make the benefit system less generous. However, this instrumental view of the Pact for reforms seems not to have worked very well – there is no systematic difference in reform activism between ‘sinners’ and the ‘good students’ as will be seen below. Moreover, the tax agenda, namely lowering average and marginal taxes, is not compatible with insisting on fiscal consolidation.

The recent reform of the Pact, that the Spring Council of 2005 accepted, is conceptually in line with a ‘need for bribes’-hypothesis. While many see this as a watering down and undue softening of the Pact, I would rather call it a prioritizing of structural reforms

[28] A NewGov project on ‘New forms of governance in the shadow of hierarchy’, led by Adrienne Héritier (EUI), explores this hypothesis inter alia. See URL: http://www.eu-newgov.org/datalists/project_detail.asp?Project_ID=05

compared to fiscal consolidation. This sequencing is in line with what the IMF (2004b) country report for the Euro area recommends. The EDP will neither be recommended by the Commission nor initiated by the Council against member state in breach of the 3% deficit criterion if the government under scrutiny can claim that it implements structural reforms, including pension reforms.[29] Thus, the EU admits now officially that there may be upfront costs of reform and that fiscal austerity is not necessarily conducive to reform, undermining its earlier rationale.

How is then the record of structural reforms in member states, the second piece of evidence for a political economy of reform perspective? The mid-term review of the Barroso Commission as well as the earlier two Kok reports were extremely negative and blamed insufficient structural reforms for low growth of the EU in general and some low growth countries specifically for being reform laggards (CEC 2005a, Kok et al 2003, 2004). Does the actual record of reforms in the member countries actually deserve this, by EU standards, rather frank critique?

For the empirical analysis of reform activism, it seems opportune to distinguish between two periods, 1987-1994 and 1995-2002, which is partly dictated by the availability of data.[30] The EU embarked on the Single Market Programme and the Maastricht strategy to the monetary union in the late 1980s and early 1990s, respectively. It was later followed up by the Amsterdam Treaty in 1997 that officially launched the reform agenda which is the focus of this paper. Table 2 in the Appendix provides some evidence for the reform activism of member states, using the social reforms database of the Fondazione Rodolfo Debenedetti. This database documents reforms in employment protection legislation and non-employment benefits in the EU-14 countries, starting in 1987 up to 2002. The main result is that member countries have become considerably more active in the second period as well as more inclined to reduce benefits for people out of work and increase incentives to work. The country entries capture the fact that reforms are largely incremental, and they sometimes point in opposite directions: countervailing reforms are indicated where there are discrepancies between low net figures in the first two columns despite a high number of reforms in the last two columns in each table 2a and 2b. Restructuring rather than retrenchment across the board seems to be the result, which confirms earlier findings by the contributions in Rhodes and Ferrera (2000). The results are also compatible with the findings of the IMF (2004a) study according to which governments are somewhat less forthcoming as regards reforms of employment protection, possibly engaging in a political exchange of lower non-employment benefits against a fiscally neutral strengthening of EPL – in fact some have increased rather than decreased EPL (see table 2a). There are also some surprises, namely the UK and Ireland tightening employment protection, starting from low levels. Another surprise is Germany where a large number of (marginal) reforms in the second period tend to go exactly in a direction that the government is always accused of avoiding. The downward pressure on wage costs suggests that these reforms are already showing economic effect, alas without

[29] For an overview of the Pact reform, see CEC (2005b: ch.II).
[30] The following draws on Mabbett and Schelkle (2005: sect. III).

much impact on the country's dismal growth rate. These findings are compatible with what the analysis of the 2004 NAPs on Employment indicate: tax and benefit reforms, in particular of marginal taxes for low-income earners, dominate the liberalisation of employment protection legislation (Mabbett and Schelkle 2005: Appendix).

How can we explain that the EU portrays the record of structural reform as more dismal than it apparently is? The theoretical literature on uncertainty and reform suggests that the restructuring of the welfare state in line with (if not exclusively induced by) the Lisbon Agenda is fraught with aggregate uncertainty, ie. winners and losers are known but the overall outcome could be, on average, worse than the status quo. The frustration expressed in the Kok reports and the Commission's Mid-term review, by contrast, suggests that the authors interpret welfare state restructuring in the member states as cases of idiosyncratic uncertainty where a Big Bang is needed to get them off the ground.[31] Deliberative political processes such as the OMCs on social policies may help to reconcile these perceptions, ie. where decisionmakers cannot even agree on the nature of uncertainty. In such a situation, the member state governments do not necessarily object to being named and shamed in this way because they can use this as proof that the reforms they implement are actually quite moderate and mindful of the social hardships they create.

4 Conclusions

This paper has argued that the framework of economic governance in the EU and EMU in particular looks rather peculiar in three respects: first, its implicit fiscal federation does not fully exploit the potential for risk sharing nor does it contain downward pressures on redistributive finance; second, the macroeconomic quartet of stabilisation has only one dominant voice, namely monetary policy, while that of wage bargain coordination is practically mute and fiscal and social policy coordination extremely devolved; lastly, its political economy seems to impose contradictory demands on governments, namely to be resolute with respect to structural reforms and to tie its hands with respect to macroeconomic management, thus creating an image of elusive government.

Yet, in a second step it was argued that an institutionalist political economy of reform can make sense of these apparent oddities and even inconsistencies. It sees domestic reform agendas rather than ever deeper European integration as the driving forces: We do not find the macroeconomic quartet in the monetary union analogous to the member states because member state governments wanted to change their domestic regimes rather than preserve and replicate it. We do not find fiscal but laboratory federalism with a weak centre in the EU because governments use soft methods of reform coordination and conspicuous fiscal austerity to get backing for their domestic reform agendas. Finally, the demands on government activism are not contradictory if we recognize the simultaneous

[31] The performance of political economies that are widely regarded as success stories, such as Ireland, Denmark, the Netherlands until recently or even Spain, do not suggest that this is a correct interpretation; each of these success stories had a long gestation period of more than a decade.

agenda of EU governments as an attempt at redefining the roles of government, in particular refusing to take responsibility for aggregate employment while being quite ready to set up microprogrammes that are meant to improve economic efficiency. In other words, this paper argues that the peculiarities of the economic governance architecture did not come about by mistake but make sense and serve the member states' political priorities at present.

However, the first step of this argument implies that this peculiar institutionalisation of economic governance is not without costs and raises the question of sustainability. At the moment, the EU is blamed for the failure of the original Pact or the apparently slow progress of the Lisbon Strategy, rather than delinquent or hypocritical member state governments. But what works well for them at the moment, may not do so for long. The recent rejections of the draft constitution in the Netherlands and in France – to which financial markets responded for the first time with a devaluation of the Euro while they had ignored bad economic news – indicated how risky this strategy of reform politics is.

While economic governance as it is set up risks to overstretch the legitimacy of European integration, the foregone fiscal opportunities for risk-sharing may be less tangible or headline-grabbing. But if they exist, they will depress growth measurably although it will be a matter of future research to provide estimates of these unexploited opportunities. Just to provide a summary of what these costs of excessive devolution are, in particular for the member states themselves (Joumard and Kongsrud 2003: table 5; par 68; par.78):

- A devolution of tax raising powers leads to unnecessarily volatile tax revenues for the member states.
- Stabilisation of the EU and that of member states would be independent of each other only if the members vulnerability to shocks were very similar and their business cycles closely synchronised; this is obviously not the case so that the member state economies get less stabilisation than they could with some risk pooling at the EU level (Kletzer and von Hagen 2000: 21, 27-29; cf. Italianer and Pisani-Ferry 1994).
- A devolution of stabilisation therefore does nothing to maintain or improve credit rating of the member economies. Balanced budget rules at the lower-tier level, to ensure creditworthiness, on the contrary tend to destabilise the member states' macroeconomies because of their pro-cyclical bias.
- Finally, the EU's simultaneous agenda creates a moving target problem for macroeconomic policy. Structural reforms of the tax system, lowering average and marginal tax rates, jeopardize effective automatic stabilisation (Mabbett and Schelkle 2005).

What this suggests is that the economic risks of the present set-up are largely on the side of stabilisation. The evidence reviewed above does not suggest an imminent crisis. Yet, one cannot help but spot a bitter irony in that the monetary union was set up to stabilise member states but is now hijacked by an agenda that could jeopardize their stability.

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Appendix

Chart 1a: Nominal compensation per employee p.a. in Germany and in EMU

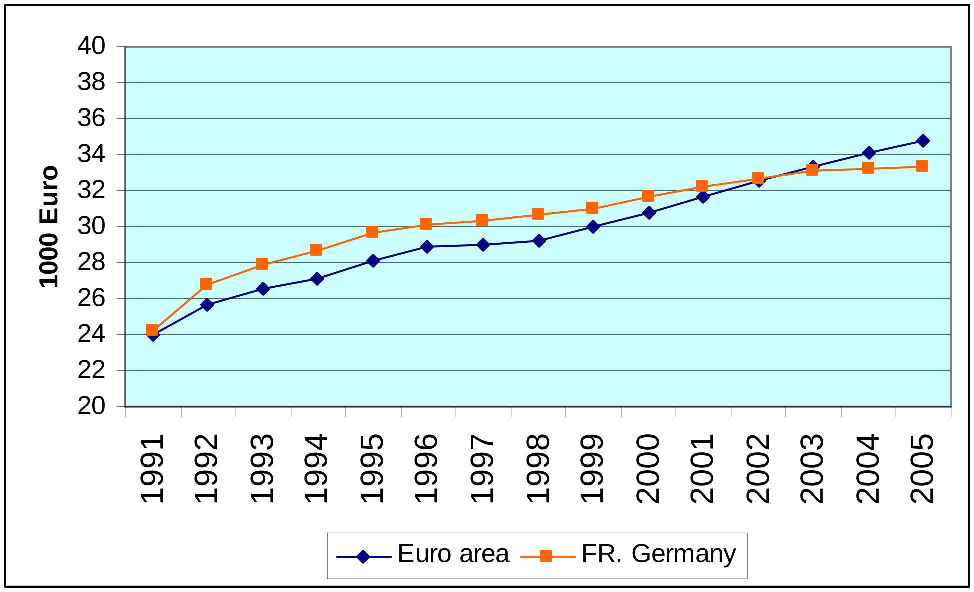
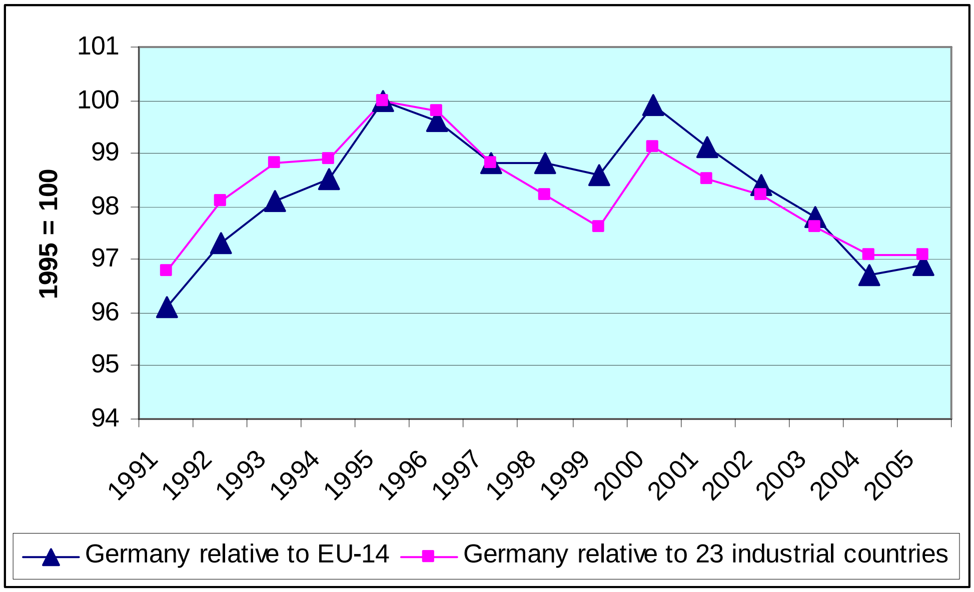


Chart 1b: Real unit labour costs of Germany relative to EU and relative to 23 industrial economies (incl. EU)



Source: AMECO database, accessed 8 August 2005; data for 2005 provisional

Chart 2a: Short term interest rates in EU-15 and the Eurozone

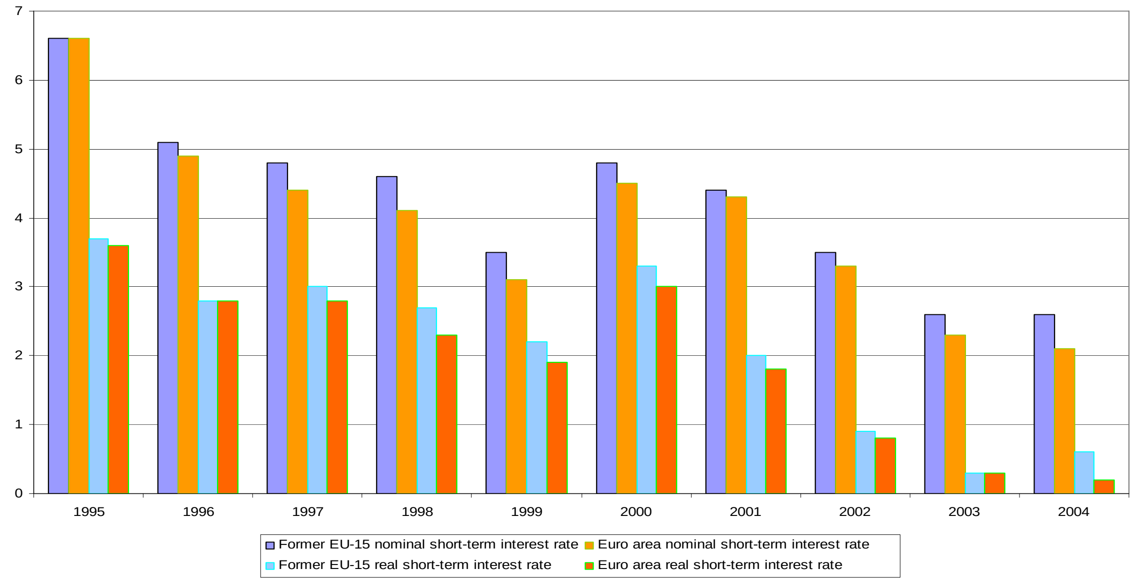
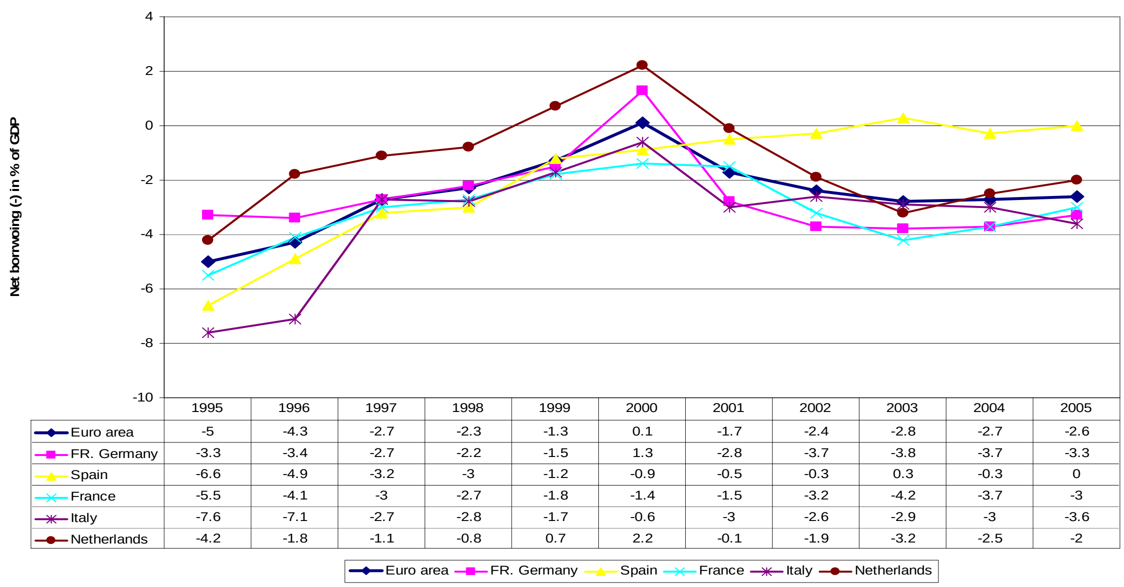


Chart 2b: Fiscal policy stance



	1995	1996	1997	1998	1999	2000	2001	2002	2003	2004	2005
Euro area	-5	-4.3	-2.7	-2.3	-1.3	0.1	-1.7	-2.4	-2.8	-2.7	-2.6
FR. Germany	-3.3	-3.4	-2.7	-2.2	-1.5	1.3	-2.8	-3.7	-3.8	-3.7	-3.3
Spain	-6.6	-4.9	-3.2	-3	-1.2	-0.9	-0.5	-0.3	0.3	-0.3	0
France	-5.5	-4.1	-3	-2.7	-1.8	-1.4	-1.5	-3.2	-4.2	-3.7	-3
Italy	-7.6	-7.1	-2.7	-2.8	-1.7	-0.6	-3	-2.6	-2.9	-3	-3.6
Netherlands	-4.2	-1.8	-1.1	-0.8	0.7	2.2	-0.1	-1.9	-3.2	-2.5	-2

Source: AMECO database, accessed 8 August 2005

Table 1: Troughs of recession in four big EMU member states

Germany	Spain	France	Italy
1998q4, 2003q2	1998q4, 2002q4	1997q1, 1999q1, 2003q1	1996q4, 1999q1, 2003q3

Source: Directorate General (2005: Box 5.2)

Chart 3a: Real short-term interest rates in EMU and the bigger member states

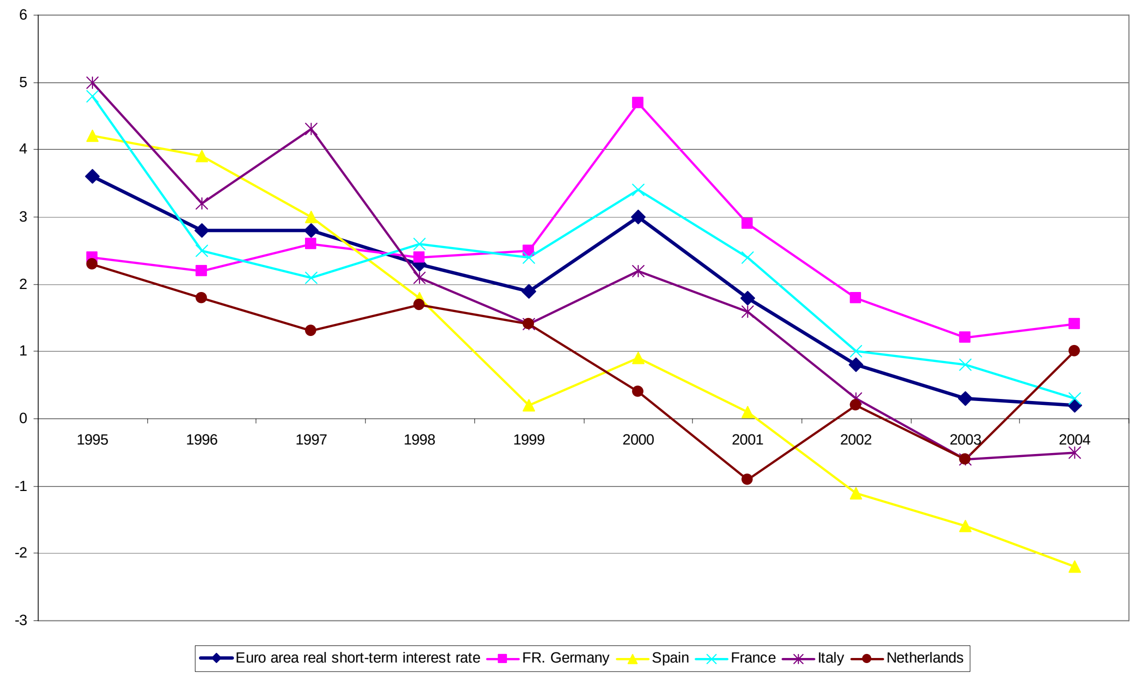
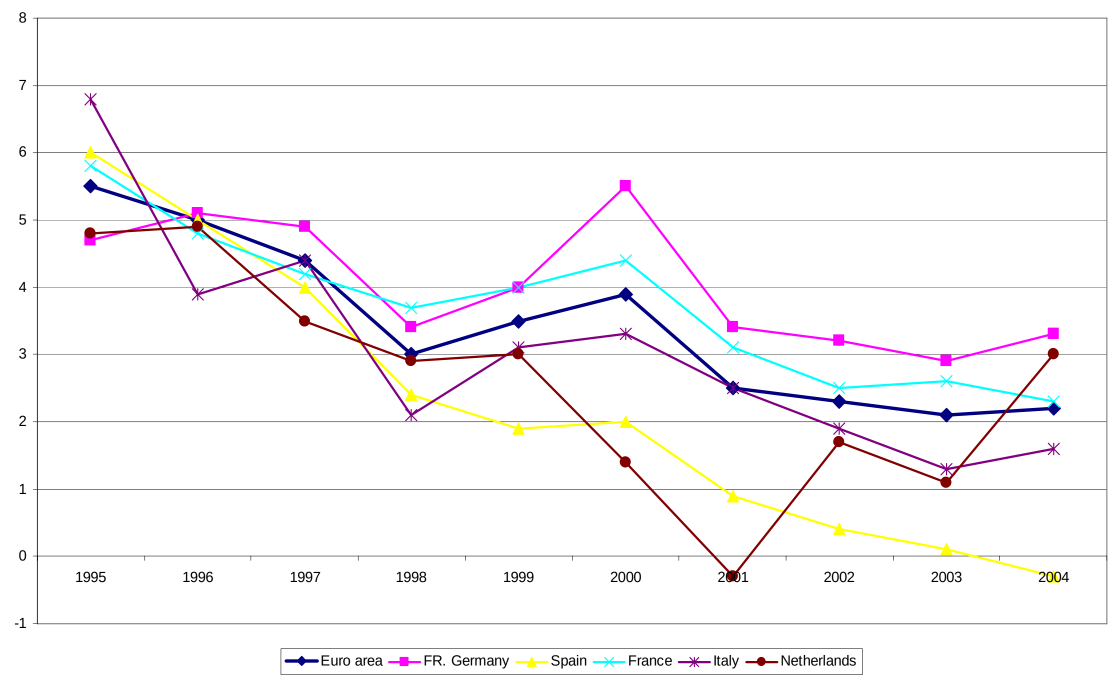


Chart 3b: Real long-term interest rates in EMU and the bigger member states



Source: AMECO database, accessed 8 August 2005

Appendix: The record on Lisbon-type reforms

The following table is based on an evaluation of the reform database maintained by the Fondazione Rodolfo DeBenedetti. The qualitative data has been operationalised in the following way: The *direction* of reforms is indicated by positive and negative values, ie. they are assigned a plus if the database classifies them as making systems more 'flexible' (less protective or generous), and, vice versa, a minus if reforms are classified as making them less flexible (more protective or generous). The *intensity* is measured by assigning a value of ±1 to 'marginal' and ±2 to 'structural' reform measures. Reform packages a series of measures get an intensity value of 2 if they contain two or more marginal measures and an additional 2 for including a structural measure (so ±4 is the maximum for the intensity of any one reform package, ±2 if it contains only marginal measures).

Table 2a: EPL reform direction[a] and intensity[b]

	Employment protection legislation		**Number of reforms[c] that make systems less (-) or more (+) flexible**	
	1987-1994	**1995-2002**	**1986-1994**	**1995-2002**
Austria	-1	+3	1 (-); 0 (+)	1 (-); 4 (+)
Belgium	+1	+2	0 (-); 1 (+)	1 (-); 3 (+)
Denmark	0[d]	+1	1 (-); 1 (+)	1 (-); 2 (+)
Finland	+2	+3	0 (-); 1 (+)	1 (-); 4 (+)
France	-5	-6	4 (-); 0 (+)	5 (-); 2 (+)
Germany	-1	+3	1 (-); 1 (+)	3 (-); 4 (+)
Greece	+2	+4	0 (-); 2 (+)	1 (-); 3 (+)
Ireland	-1	-5	2 (-); 1 (+)	5 (-); 0 (+)
Italy	+1	+8	2 (-); 2 (+)	0 (-); 6 (+)
Netherlands	+1	+5	1 (-); 2 (+)	1 (-); 4 (+)
Portugal	+2	-2	1 (-); 2 (+)	7 (-); 4 (+)
Spain	+1	-2	1 (-); 1 (+)	5 (-); 2 (+)
Sweden	+1	+3	0 (-); 1 (+)	1 (-); 2 (+)
United Kingdom	0[d]	-6	1 (-); 1 (+)	7 (-); 1 (+)
Number of reforms[c]	**15 (-); 16 (+)**	**39 (-); 41 (+)**	**15 (-); 16 (+)**	**39 (-); 41 (+)**

Table 2b: Benefit reform direction[a] and intensity[b]

	Non-employment benefits		Number of reforms[c] that make systems less (-) or more (+) flexible	
	1987-1994	1995-2002	1987-1994	1995-2002
Austria	0[d]	+8	1 (-); 1 (+)	3 (-); 7 (+)
Belgium	+4	+5	1 (-); 4 (+)	2 (-); 6 (+)
Denmark	+4	+9	1 (-); 3 (+)	1 (-); 6 (+)
Finland	+2	+13	0 (-); 1 (+)	1 (-); 10 (+)
France	+2	-6	0 (-); 2 (+)	11 (-); 7 (+)
Germany	-1	+14	2 (-); 1 (+)	1 (-); 14 (+)
Greece	-2	+5	1 (-); 0 (+)	0 (-); 4 (+)
Ireland	+6	+8	0 (-); 4 (+)	1 (-); 8 (+)
Italy	0[d]	+5	2 (-); 2 (+)	1 (-); 6 (+)
Netherlands	+1	+19	3 (-); 3 (+)	1 (-); 16 (+)
Portugal	-2	-1	3 (-); 1 (+)	5 (-); 5 (+)
Spain	+4	+2	0 (-); 3 (+)	2 (-); 4 (+)
Sweden	+3	+12	1 (-); 3 (+)	0 (-); 9 (+)
United Kingdom	+5	+11	0 (-); 3 (+)	2 (-); 8 (+)
Number of reforms[c]	**15 (-); 31 (+)**	**31 (-); 110 (+)**	**15 (-); 31 (+)**	**31 (-); 110 (+)**

a - for reducing, + for increasing the flexibility of the system (EPL) or rewards from the labour market (NEB), according to the Fondazione RDB database.

b ±1 for 'marginal' reforms, ±2 for 'structural' reform measures; one reform package can contain several (marginal) measures thus valued.

c Number of (more or less flexibilising) reforms irrespective of intensity (third column in database); but if reform package contains countervailing measures, net value determines whether classified as + or -.

d Countervailing measures cancelled each other out.

Source: Fondazione Rodolfo Debenedetti social reforms database (URL: http://www.frdb.org/documentazione/centro_doc.php), accessed 4 April 2005.