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The Economic Crisis and European Integration

The Economic Crisis and European Integration

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1. Introduction and Outline

Wim Meeusen

The Credit Crunch and the ensuing financial and economic crisis of 2007-2009 did not only strike hard at the economy in the Western world itself, but also at its policy-makers, many of whom lost their bearings, at economics as a scientific discipline and, specifically, at the process of European integration itself. The latter aspect of the crisis was the theme of a conference held at the European Parliament on 2 June 2010 in Brussels, under the title 'The Economic Crisis and the Process of European Integration'. Obviously, the other aspects mentioned were never far away. The papers in this volume are a selection of the keynote addresses and of the contributions to this conference.

In Part I European governance issues are discussed. *De Grauwe*, in Chapter 2, argues convincingly that the present sovereign debt crisis in a number of Western economies finds its origin in unsustainable debt accumulation in the private sector and the operation of automatic stabilisers set in motion by the economic crisis. A tightening of the parameters of the Stability and Growth Pact of the EMU, regardless of the fact that this pact did not work well in the past, is therefore not the right answer. De Grauwe subsequently asks the question why there is presently such a high degree of macroeconomic divergence in the eurozone. After having dismissed a number of alternative explanations, like structural rigidities on labour markets, he concludes that 'idiosyncratic' (i.e. national) credit-fuelled 'animal spirits' must lie at the source of the crisis and the divergence across countries it created. The ECB, being responsible not only for price stability but also for financial stability, is in his view the right instance to deal with this. Its ability to apply differential minimum reserve requirements and to impose anti-cyclical capital ratios should be used to the full, and it should follow up its presidency of the recently created European Systemic Risk Board (ESRB) by action, and not only by issuing warnings.

Ioannou and Heipertz, in Chapter 3, write in the same vein. They forcefully advocate more political integration in the EU. Their thesis is that, more than being desirable as a matter of principle or from a normative, federalist point of view, increased political integration, in the face of the economic cri-

sis and the divergence it caused across EU member states, should be seen as a necessary pre-condition for improving socio-economic performance in the EU. They argue that a 'quantum leap' in the political governance of the EU is necessary to continue to be able to provide 'SEES' ('stability, equity, efficiency and security' (Padoa-Schioppa et al., 1987) in a period when the crisis has incited nation states to retreat behind their own borders, possibly endangering the long-term survival of the eurozone itself.

While the sovereign debt lapse is indeed a consequence rather than a cause of the present difficulties in the EU and the EMU, it became at the same time of course also a problem in itself. In Chapter 4, *Lejour, Lukkezen and Veenendaal* therefore examine in a technical way the sustainability of government debt in Europe. They carefully provide results for a number of alternative but related key indicators of debt sustainability under a few scenarios. The 'usual suspects' surely come out, but there are also some surprises. When the extra costs related to an ageing population are taken into account Germany, France, the Netherlands, Spain, Italy and Portugal have to make larger efforts than the present ones to maintain sustainability of debt. Surely, in Greece and Ireland these efforts should be even more considerable.

Coniglio and Prota look in Chapter 5 into intra-country regional convergence/divergence and the role of economic and financial crises herein. They note that current growth theory does not yield consistent answers, and they therefore come up with a challenging hypothesis that would explain the observed 'accordion effect', i.e. the succession over time of increases and decreases of the movement towards convergence in many EU member states. The clue would be that less developed regions are hit by the negative shocks more severely than rich regions because existing firms localised in central regions are on average more modern and technologically more advanced, and thus better able to adjust their production to the shocks. Moreover, in the lagging areas spells of unemployment in the workforce induced by adverse shocks will with a higher probability lead to a permanent loss of skills and to a faster obsolescence of the stock of equipment and infrastructure (hysteresis).

In Chapter 6, *Sarisoy Guerin* deals with a more specific question of European governance. She empirically examines whether Bilateral Investment Treaties (BITs) have the desired positive effect on FDI inflows and outflows. She also addresses the question whether the transfer of competences from the member states to the EU for the conclusion of new BITs and the 'grandfathering' of existing BITs by the EU is expected to be beneficial.

Part II of the book is devoted to the effect of the crisis on global economic imbalances. *Bagliano and Morana*, in Chapter 7, ask the question if economic and financial crises in the US have had influence upon economic convergence in the euro area. They use a factor vector autoregressive (F-VAR)

econometric methodology. They convincingly show that the interaction between US and EA real and financial markets are complex and involve not only first, but also second and third moments. One of their results is that there is no evidence for a linkage between the state of the US business cycle and inflation dynamics in Europe. This result is however less striking than it may seem, in the light of Leijonhufvud's argument that (in spite of the new-classical and new-Keynesian inflation-targeting rhetoric of the Fed and also of the ECB) the inflation rate in both regions, in reality, is determined by not much more than massive cheap but highly price-elastic imports from China (Leijonhufvud, 2008).

Lee, in Chapter 8, also uses a VAR econometric methodology, the S-VAR (structural vector autoregression) method popularised by Blanchard and Quah (1989), but in a context in which he examines whether a US dollar peg or, alternatively, a euro peg system for the Chinese yuan would be warranted in the light of sufficient symmetry between these entities of aggregate demand and supply shocks. His conclusions are mixed. His relatively positive evaluation of the euro peg alternative is not derived from any observed tendency to greater symmetry between macroeconomic shocks in Europe and China, but rather from the longer-term convergence one might expect on the basis of the endogeneity argument of Frankel and Rose (1998).

In Chapter 9, *Berger and Nitsch* examine the source of the observed increase in trade imbalances between countries (EU, EMU and non-EU), and more in particular the role of inflexibilities, both on labour, exchange and goods markets. Their empirical econometric approach is a neat and transparent one. Their conclusion is, not surprisingly, that all three of these inflexibility types matter to explain the persistence and sometimes increasing degree of trade imbalance, but that this should not lead us to doubt the efficiency of a monetary union if at the same time one tries to introduce more flexibility on national labour and goods markets.

Qian, in Chapter 10, goes in great detail into the issue of the supposed excess liquidity in China and its possible relation to financial risk. He questions the results obtained by Zhang and Pang (2008) and Zhang (2009). With the help of a careful econometric study he finds that excess liquidity has not significantly affected China's CPI inflation rate. Rather, a large amount of the over-supply of money has entered the real estate market through direct FDI and other channels. That in itself is however sufficient to conclude that the risk of a Chinese real estate bubble is not to be taken lightly.

In Part III of the book we have collected papers that deal with the euro perspectives and financial perspectives in Central and East European countries (CEEC) after the crisis. In Chapter 11, *Lewis*, in a sweeping empirical study of the main indicators, demonstrates that it is mainly the Maastricht deficit criterion that creates a problem. What seemed, before crisis, to be a

cyclical issue, now turns out to have a structural character. But also the problems with the exchange rate, inflation and interest rate criteria seem to be challenging. Overall the euro prospect is receding in CEEC, at least in the medium-run.

Pirovano, Vanneste and Van Poeck, in Chapter 12, empirically examine the patterns and determinants of the inflow of portfolio and short-term capital in the new and potential EU countries. They explicitly differentiate between ‘push’ and ‘pull’ factors. New and potential member countries show a clearly different pattern. All in all, they observe that the potential member countries are on average less exposed to short-term capital inflows, while many of the new member countries rely heavily on this form of financing. It also appeared that portfolio and other investment flows (bank loans, trade credits, transactions in currency and deposits and other short-term capital) are very different in nature and can hardly be grouped under the same heading.

Chapter 13, by *Horobet and Dumitrescu*, focuses on the role of diversification in investment behaviour in old and new EU member states and in a few important non-EU countries. More in particular the authors consider the possible, but theoretically ambiguous benefits for eurozone investors of holding internationally diversified portfolios, as compared to other investors. It would seem that diversification benefits are still high for a eurozone investor and they have slightly increased after 2004. In times of financial crisis international diversification may bring attractive benefits in the form of low portfolio volatility, although these benefits are smaller than in normal times.

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PART I

Global European Governance after the Crisis

3. EMU, Political Union and Economic Performance: Lessons from the Stability and Growth Pact and the Lisbon Strategy

Demosthenes Ioannou and Martin Heipertz[1]

1. INTRODUCTION

We argue that bold progress in political integration has become a necessary condition for substantially improving the institutional preconditions for the economic performance of the European Union (EU) as a whole. While the Economic and Monetary Union (EMU) has in its short existence shown that it can function even in times of crisis without a fully-fledged political union, we hold that a greater level of political integration would, ceteris paribus, enhance EMU's performance by improving the institutional framework conditions of the European economy. We develop a conceptual framework that explains the links between political integration and economic performance in the EU context. We look for an empirical confirmation of our proposition in the functioning of the Stability and Growth Pact and the Lisbon Strategy during the first eleven years of EMU.

What should be the 'finalité' of the European integration process? The United States of Europe, a confederation of sovereign nation states, a free trade area or some unfinished sui generis form of governance structure, continuously in the making? The normative debate between pro-integrationist federalists and opposing defenders of national sovereignty is as old as the process of integration itself. Recently, it has re-emerged in the context of how the economic governance framework should be adapted to ensure a smooth functioning even at times of crisis.

Beyond the ideological dispute between integrationists and defenders of national sovereignty, there are sober and objective practical arguments that speak in favour of further integration towards a deeper political union. Al-

ready during the negotiations over the blueprint of monetary union, that is, of the Treaty of Maastricht in the early 1990s, the Deutsche Bundesbank, for example, had advocated political union as a necessary complement to EMU in the long run (e.g. Deutsche Bundesbank, 1990). A number of observers and policy makers have argued the same over the years before as well as after the introduction of the euro (De Grauwe, 2005, and in this volume). But why is it precisely that EMU should require further political integration and, by extension, a much deeper political union?

Avoiding a normative discussion on the intrinsic desirability of further political integration, we argue that a deeper political union should be seen as a precondition for improving socio-economic performance in the EU, given that the degree of political integration is central in shaping economic governance in the EU. This argument is based on extending the central theme of economic institutionalism to European integration, namely, that institutions in the long run are the main determining factors of economic performance.

In the European context, the economic performance of the EU member states and the EU as a whole depends on the process of integration because, by definition, national and European political and economic institutions are shaped by that process of integration (Jones, 2002). Therefore, if the current level of political integration can be shown to be leading to suboptimal institutional solutions (which in turn lead to suboptimal economic outcomes), then the present institutional framework of the EU can be seen as placing a cap or premium on the EU's economic performance. If a higher level of political integration led to a better institutional framework, economic performance would, ceteris paribus, improve.

More precisely in our argument, a higher degree of political integration would allow to adapt and innovate the institutional framework for EMU so that, over time, more effective solutions could be found that currently remain simply 'out of reach' for the EU polity. A stronger form of political union would allow for more adaptation and thereby entail a much wider solution space than the currently, limited level of integration. Political union is thus raised not as a sufficient but rather as a necessary condition for improved governance and economic performance.

The above set of causal relationships is summarised in the flow chart of Figure 3.1. Apart from the variables already mentioned, the chart includes the notions of input and output legitimacy. These two forms of legitimacy create a conceptual link between deeper political integration and economic performance. Input legitimacy in any democratic political system is a *sine qua non* condition for its long run survival, reflecting popular assent. In the case of the EU, it is also a necessary condition for deeper political integration. Input legitimacy is also the possible result of political integration in the sense that the process of integration can provide for better participation and democratic

accountability of European institutions. Output legitimacy in turn is ensured when, broadly speaking, the provision of socio-economic performance is deemed to be adequate by those participating in the political process.

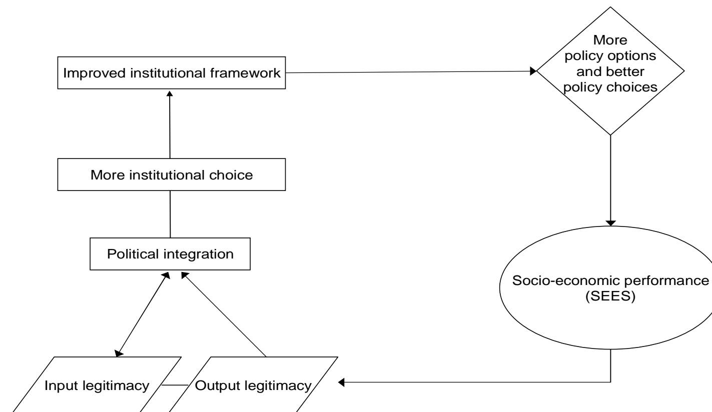

Figure 3.1 Causal relationships between political and institutional integration and economic performance

As an example of how these causal relationships may play out in reality, one can view the Lisbon Treaty as a step towards deeper political integration. The new Treaty provides some, albeit incremental, institutional solutions for solving policy problems more effectively. These institutional solutions allow for better policy choices which in turn should lead to improved socio-economic outcomes. Such outcomes legitimise the authorities that provide them (output legitimacy) and may thereby give an impetus to further political integration. The new treaty may also be viewed as increasing the degree of input legitimacy, having given significant new powers to the European Parliament.

The parameters presented in Figure 3.1 can be both dependent and independent variables. Higher levels of legitimacy, for example, can be the cause as well as the result of better institutional solutions and policy choices. Moreover, each causal relationship also implies a potential constraint from one variable to the next.

2. THE CONCEPTUAL FRAMEWORK

We argue that the EU finds itself in a 'half-way house situation' in terms of institutional development and governance effectiveness. The metaphor of a 'half-way-house' points to the incomplete nature of the process of European integration.[2] At the start of the integration process, one can expect an inverse relationship between integration and the effectiveness of governance. This occurs because of developments both at the national and the European level. At the national level, a reduction in effectiveness is likely due to the asymmetric degree of integration in different policy domains (Scharpf, 1997a).[3] At the European level, the creation of a new form of governance requires time to take hold and consolidate. Moreover, it is the product of suboptimal negotiation outcomes (Moravcsik, 1998; Scharpf, 1997a), and it is moving in incremental steps that entail uncertainty, arguably also due to the fact that the end-state of the process itself remains undefined and due to enlargement rounds ('widening') that result in increasingly divergent preferences and interests that are not paralleled by sufficient and proportional 'deepening' of governance. Under these conditions, and as long as the integration process remains incomplete, the effectiveness of the overall governance framework may be affected adversely.

We define 'effectiveness of governance' as the capacity of a polity's institutional structure and political processes to deliver highest-order policy goals as summarised under the quartet of stability, equity, efficiency and security (SEES), a concept adopted by the report of Padoa-Schioppa et al. (1987) and used here to denote a formalised and idealised set of socio-economic outcomes. For the sake of completeness, we define 'stability' as sustainable, non-inflationary economic growth in the absence of volatility and financial or economic crises, 'equity' as the absence of extreme inequalities and a reasonable degree of social cohesion, not least through equality of opportunity, 'efficiency' as the optimal relationship between policy inputs (usually in the form of financial resources) and policy outputs and, finally, 'security' as the containment of external and internal threats to the peaceful existence of a polity.

One can depict this evolution over time in the stylised representation of Figure 3.2. Under the 'half-way house' metaphor, the governance of the unitary nation state within the international order of the 1950s (Scharpf, 1997b) is eventually transformed through the integration process: SEES is now to be provided by the interplay of integrated nation states within the European framework of multi-level governance (MLG). However, this cooperative and federalist[4] framework needs to ensure that it safeguards SEES and delivers not only by historical standards but also in line with citizens' increasing expectations and in an environment of increasingly tough international competi-

tion. A shortfall in any one of these dimensions may thus be explained as the discrepancy between the concrete, institutional and policy-induced assignment of competences and the ideal assignment of competence according to the theoretical principles of collective action and public goods (e.g. Olson, 1971).[5]

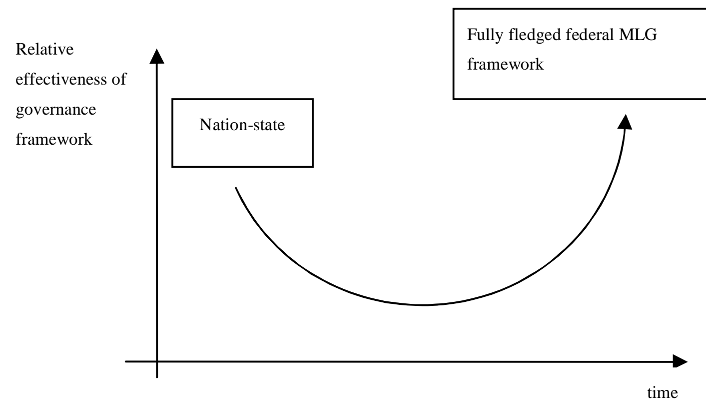

Figure 3.2 European integration and governance effectiveness

Centrally to our proposition, we argue that there is a link between the effectiveness of the EU governance framework and the polity's ability to provide SEES. The sub- optimal governance framework due to incomplete integration is seen as the principal cause of a certain, endogenous component of SEES shortfall. This is in line with the findings of the institutional economics literature which broadly defines institutions as 'the rules of the game in a society or […] the humanly devised constraints that shape human interaction (and) […] structure incentives in human exchange, whether political, social or economic' (North, 1990, p. 3). Economic outcomes are in the long run determined by the institutional set-up and the policies that this set-up enables (e.g. North, 1990; Matthews, 1986). In the extreme, as Olson (1996, p. 20) has put it, 'the great differences in the wealth of nations are mainly due to differences in the quality of their institutions and economic policies'.[6]

Applying this perspective to European integration suggests that an institutional set-up at a 'half-way house' state is suboptimal when compared to a more complete institutional structure that is capable of adapting to changing circumstances and of designing and implementing more efficient and more effective policy. A point to be stressed in this context is that, within the politico-economic institutional framework that has resulted from the current level

of European integration, the economic outcomes may be (close to) optimal. However, with greater political integration, a higher provision of SEES could *ceteris paribus* be possible. In the case of economic governance under EMU, while it may be perceived as providing the most advanced governance solutions given the current level of integration, it appears suboptimal from a perspective of a 'political EMU', that is, a much more politically integrated structure for members of the euro area, or more broadly, a deep 'political union' among all EU members that participate in monetary union, much beyond the economic sphere. Such a 'quantum leap' in the governance of the euro area holds the potential for a much higher provision of SEES.[7]

The next conceptual step in our argument is 'legitimacy' as the link between the effectiveness of the EU governance framework and political integration. The EU's institutional and policy effectiveness is defined by the degree of input and output legitimacy, in turn dependent on the level and quality of integration.

Legitimacy can be understood to exist in two forms, following Scharpf (1997a). First, 'input legitimacy' is the acceptance of governance and political choices by the citizens of a polity thanks to participation in the political process, ranging from the selection of political leadership to the shaping of political decisions and socio-economic outcomes. As Lenaerts and Gerard (2004) explain, input legitimacy addresses the question of direct legitimisation of political power through the democratic participation of the citizens or their elected representatives in transparent decision-making and constitution-making procedures (see also Stein, 2001).

Second, 'output legitimacy' is defined as the problem-solving capacity of a polity and its institutional framework, or the legitimacy acquired through effectiveness. Output legitimacy measures the extent to which citizens see their interests and desires mirrored in the outcomes of political processes and therefore accept and support the political order as 'effective' (as opposed to 'right', which would relate to input legitimacy and the process of policy rather than its outcome). Output legitimacy can therefore be seen as the type of legitimacy that is associated with an adequate provision of SEES as developed above. Provided that the EU manages to provide its citizens as a whole with adequate levels of SEES, it is likely to enjoy a certain level of output legitimacy even if it does not enjoy enough input legitimacy.

Whether one form of legitimacy is more important than the other in the EU context is an important part of the debate. Collignon (2005), for example, suggests that in a context of deep economic integration, input legitimacy grows in importance. At the same time, some observers (e.g. Pisani-Ferry, 2005) have held that the rejection of the Constitutional Treaty was the outcome of inadequate output legitimacy. In a fully integrated political system, both forms of legitimacy are necessary but can, up to a point, be complemen-

tary. At the same time, providing one form of legitimacy depends on the other; output legitimacy in particular is conditioned by the degree of input legitimacy (cf. Scharpf, 1997a). Moreover, perceptions of output and input legitimacy of the EU level of governance is also very strongly conditioned (and often mixed up with) the output and input legitimacy of the national level of governance. In sum, the processes that deliver input legitimacy are not disconnected from the achievement of output legitimacy, and the realisation of one of the two interconnected notions of legitimacy depends mutually on the fulfilment of the other. Additionally, both forms of legitimacy are necessary for enhancing equity and efficiency.[8]

Against this background, European integration can be viewed as a process which furthers the attainment of input and output legitimacy. To the extent that input legitimacy is found lacking, the process of integration is incomplete and fulfils only partially those 'structural preconditions on which authentic democratic processes depend: European political parties, European political leaders, and European-wide media of political communication' (Scharpf, 1997a).

The above string of arguments may be presented in a stylised fashion as in Figure 3.3. In the context of the EU integration process, the EU political structure is associated with a 'frontier' of input and output legitimacy. The effectiveness of the governance structures determines the maximum level of SEES that citizens can enjoy, constrained at the same time by the degree of input legitimacy of those structures.[9] The frontier between output (SEES) and input legitimacy determines all possible socio-economic outcomes, denoted here as the 'frontier of socio-economic outcomes' or FSEO, and represented by the line AA'. AA' thus engulfs all outcomes that are possible under the current parameters set by the level of political integration in EMU/EU. One may formally say that the two forms of legitimacy are the (political) inputs, the combinations of which determine the frontier of possible (socio-economic) outputs. We depict the shape of this frontier in stylised fashion, acknowledging that only empirical research could identify the mix of input and output legitimacy that would allow for and support specific institutional set-ups and thereby socio-economic outcomes in the EU.

For the sake of demonstration, one may represent the current position of EMU in terms of political integration by point X. With incremental changes within the current political-economic framework, EMU may marginally optimise its functioning and move onto the frontier AA' at point X'. In institutional terms, such an incremental improvement could take the form of making use of currently unused provisions in the Lisbon Treaty. However, only considerable progress in political integration would push the possibility frontier of socio-economic outcomes outwards to BB'. At the same time, accord-

ing to Collignon (2005), such an integration 'leap' would need to satisfy input legitimacy concerns, i.e. popular acceptance for and participation in deeper integration.

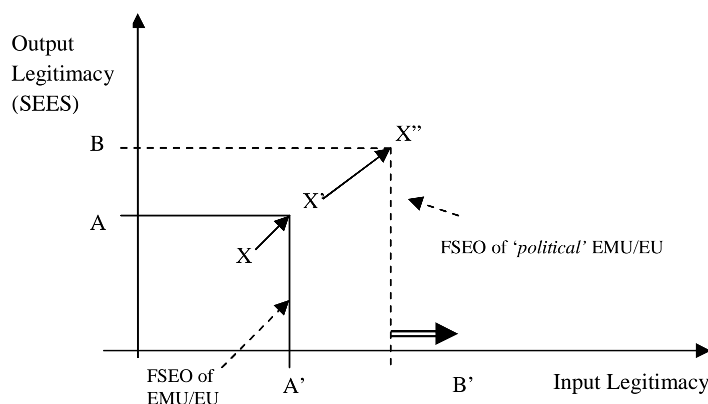

Figure 3.3 The constraint of EU political integration on the provision of SEES

Once significant progress in political integration has occurred, the current optimum (X') becomes suboptimal compared to the new optimal point denoted here by point X'' on the possibility frontier BB'. Therefore, only from a perspective of deeper political integration can one argue that the current functioning of EMU is suboptimal and that 'there can be little doubt that the absence of a political union is a serious design flaw in the European monetary union that will have to be remedied to guarantee the long-run survival of the eurozone' (De Grauwe, 2006). By contrast, within the current parameters set by the present level of political integration, EMU is functioning (close to) the feasible optimal level (X or X'). At the same time, the issue has important implications, not least if indeed the SEES premium on the present, relatively suboptimal state of affairs is so large that lacking governance effectiveness undermines the (output) legitimacy of the existing institutional set-up.

Although we focus here on political EMU, the interdependencies between economy and polity imply that further political integration not only in the economic domain but also in non-economic fields, such as defence/security, foreign policy or justice and home affairs, would contribute to an overall improvement.[10] However, a thorough analysis in such other, non-EMU policy areas, would transgress the scope of the present analysis, which restricts itself

to the empirical investigation of the extent and quality of political integration in the internal dimension of economic governance.

3. LESSONS FROM THE SGP AND THE LISBON STRATEGY

To validate the above conceptual framework and to illustrate the constraining impact of the current, limited depth of political union, we turn to empirical evidence in the functioning of the Stability and Growth Pact (SGP) and the Lisbon Strategy in the first 11 years of EMU. The current economic governance framework has failed to deliver fiscal consolidation and structural reform and insufficiently addresses spillovers and imbalances existent in monetary union. The EU and its constitution of EMU importantly lack the capability of effective, thorough and swift institutional adaptation in times of crisis and in the face of growing geopolitical competition, beyond the implementation of mere short-term emergency back-stops.

3.1. The Stability and Growth Pact

The EU's rules-based fiscal policy framework as enshrined in the present Treaty is built on national institutions and decision-making. The purpose of the very limited European component to this framework is to counter perverse incentives at the national level that cause or enhance a 'deficit bias' of public finance, i.e. a predisposition of national governments in favour of conducting imprudent, unsustainable fiscal policies.[11] The SGP's 'excessive deficit procedure' defines the conditions under which a general government deficit ratio above the reference value of 3% of GDP is considered 'excessive' and prescribes procedural steps by which the EU Council of Ministers of Finance and Economy (ECOFIN) deals with that situation – ultimately, by issuing financial sanctions to the country in question. Besides this 'corrective arm' of the Pact, a 'preventive arm' prescribes a rudimentary form of budgetary co-ordination and surveillance, centred on the annual submission of so-called 'Stability and Convergence Programmes' by Member States who define their own 'medium-term budgetary objectives' (MTOs) in structural terms to achieve sound budgetary positions over the economic cycle.

In practice, the SGP can be said to suffer from a 'dilemma of self-commitment' (Heipertz, 2005). As Member States commit to budgetary targets and deficit ceilings, they inevitably agree to limit their budgetary room of manoeuvre. A Member State, in order to respect the 3% of GDP reference value, accepts a potentially very significant loss of sovereignty over fiscal policy. While such commitments can be taken at low cost ex ante, their actual

implementation has in practice been seen to be frequently overridden by the political economy of public budget-making as well as the complexity and unpredictability surrounding outcomes and domestic political requirements of national fiscal policies.

At the frustration of the European Commission and the ECB, fiscal policymakers have in the past often seemed unable or unwilling to live up to fiscal commitments for their intrinsic value, sometimes also at comparatively low political cost. By consequence, the dilemma of self-commitment consists of choosing between, on the one hand, accepting and living up to the voluntary reduction of fiscal discretion through credible commitments (which would have to be attained also at high political costs) and, on the other hand, retaining de facto fiscal discretion and a politically desirable 'marge de manoeuvre' at a minimum degree of externally imposable fiscal discipline at the cost of, whenever necessary, violating previous commitments, which would be bound to undermine their credibility over time. Experience has shown that, in most cases, policymakers confronted with the dilemma have opted for the latter option, in the light of domestic priorities. This also means, however, that the EU fiscal framework entails a governance gap. Notably, since market forces imposing fiscal discipline may be augmented under EMU, governance needs to ensure an equivalent disciplining structure through appropriate coordination. The adverse effect of failing to close this gap can be felt very strongly at times of financial and economic stress. Therefore, transferring some 'guidance' role for fiscal policy-making to the European level, as part of a more mature form of political union, could represent an institutional arrangement that delivers more effective co-ordination of fiscal policies than the status quo, which evidently has been unable to prevent excessive fiscal laxity.

Regardless of the precise form of such more extensive fiscal policy coordination, the crucial advantage of deeper political union – rather than cornering the EU into one single and permanent institutional solution such as the present SGP – would be the option to adapt different policy solutions and institutional designs through decision-making that depends on performance and legitimacy. By contrast, the absence of deeper political union automatically rules out a thorough adaptation and improvement of the institutional framework and leads the EU to be 'stuck' with an arrangement that is the path-dependent, petrified outcome of a drawn-out genesis of political compromise brokering in the 1990s (Heipertz and Verdun, 2010).

Experience up to now, and the extreme tensions in debt markets revealed during the crisis, do not seem to support the view that the SGP in its present form can effectively address the persistent problem of fiscal imbalances in the EU and implement a structural adjustment of public finances. Consequently, the present level of integration not only does not allow for fiscal synergies at the European level through a selective and gradual replacement

of national spending items through an appropriately sized federal budget responsible for areas of common concern (e.g. security), but does not even represent a sufficient external lever against national deficit bias and the danger of free-riding, up to the fact that the fiscal situation in some EU countries has become untenable without external stabilisation.

The opportunity cost of the present framework might be considerable. While EMU continues to function even in times of crisis thanks to considerable emergency measures, one cannot ignore the possibility that a continued, unsustainable course of fiscal policy could still damage the edifice beyond repair. Importantly, as said before, economic governance without deeper political union remains 'stuck' within the boundaries of the present institutional framework, regardless of its performance under increasingly complex and challenging conditions.

3.2. The Lisbon Strategy

Between 2000 and 2010, the Lisbon strategy was at the centre of socio-economic discourse in the EU. In the end, it proved unsuccessful in meeting by 2010 its extremely ambitious overarching goal of making the EU 'the most competitive and dynamic, knowledge-based economy in the world'.

The goals, functioning and impact of the Lisbon Strategy – as well as its successor, the EU 2020 strategy, which entails a number of the former goals and objectives while also having to take into account the implications of the global financial crisis – illustrates both the policy ambitions of the EU as well as the shortcomings in terms of governance for achieving them. In analytical terms, the Lisbon Strategy reflected very much the SEES quartet of the approach used in the conceptual section above: the original goal of the Strategy indicated that the EU seeks not only efficiency (i.e. the optimal relationship between policy inputs and outputs through higher levels of competitiveness, productivity and employment) but also social cohesion, or more broadly, 'equity'. As explicitly stated in the European Council conclusions of 2000 that set up the Lisbon Strategy, achieving efficiency and equity requires macroeconomic stability. Finally, the Lisbon Strategy ambitions implicitly acknowledged the need for security as a necessary basis for achieving efficiency, equity and stability. But did the EU multi-level governance structure have the necessary policy tools and enjoy adequate input legitimacy to achieve such ambitious, output-oriented, goals?

Following some years of learning-by-doing in the first half of the 2000s, the Lisbon Strategy underwent a mid-term review in 2005, at the same time as the SGP review. This medium-term review illustrated the legitimacy constraint problem that confines the number, as well as quality, of possible institutional solutions to problems of economic governance in the EU. More spe-

cifically, in 2005, several recommendations of the so-called Kok and Sapir Reports for strengthening EU economic governance were in the end not taken up.[12] Similar to some of the most constructive Commission proposals on strengthening the SGP framework, these recommendations for improving the framework were ignored and the Lisbon mid-term review was essentially limited to a streamlining of the multilateral surveillance procedures. And while such a streamlining was much needed at the time, it was a solution that had to remain within the existing boundaries of political integration. The mid-term review did not tackle therefore the more fundamental coordination problems at the EU level. It did not, for example, seek to strengthen benchmarking and peer-pressure, let alone introduce additional and more effective ways of policy-making. Instead, and again similar to the SGP reform, the mid-term review focused on ways to enhance the so-called 'national ownership' of the strategy, which meant a greater focus on the national aspects of governance of the Lisbon strategy.

However, contrary to original expectations, it appears that stronger forms of coordination in the structural reform area are not much less important than those for fiscal policies for the stability of the EU economy. While in the first years of EMU it was felt that the economic case for supply side coordination was 'weak'[13], persistent national divergences especially in competitiveness positions, the importance of cross country policy spillovers and inadequate single market integration proved to be a major challenge for the EU economy in times of crisis. Consequently, the calls in 2005 by observers to increase the Commission's powers, and/or the setting up of independent agencies with the power to enforce already existing rules, to deepen the single market and increase its efficiency were not heeded. Independent agencies would have avoided, for example, the reproduction at the EU level of the 'capture' of national governments by national interest groups. Instead, as suggested at the time, 'the European level of government does not have the political legitimacy needed to arbitrate among opposing interests.'[14]

The direction taken in the 2005 reform to focus on increasing national ownership while failing to provide for governance solutions at the EU level, reflects the proposition that the lack of possible institutional arrangements at the European level resulted in a form of 're-nationalisation' of the structural reform agendas of Member States. Consequently, the Kok Group's recommendation to construct 'league tables' and praise good performance while castigating bad, was in the end not taken up. Policy makers did not seek to 'benchmark member states' performance and preferred avoiding the political consequences of too apparent non-delivery.[15] The mid-term review also ignored recommendations linked to the allocation of the EU budget's resources.[16] This, too, however, would seem to go beyond the 'legitimacy frontier' of the governance status quo. Finally, it is hardly surprising that any

more ambitious suggestions, such as upward delegation to independent agencies, were also put aside.

To sum up, instead of seeking ways to improve governance effectiveness also at the EU level, the SGP and Lisbon Strategy reviews of 2005 largely sought to increase 'national ownership' and to employ the legitimacy of national actors in order to implement the necessary fiscal consolidation and structural reforms. As the Commission staff put it at the time concerning the Lisbon Strategy: 'There is a lack of legitimacy and political support to the whole Lisbon strategy.'[17]

In the case of the Lisbon Strategy, increasing legitimacy and support for reform was sought through an attempt to increase the involvement of national stakeholders in the structural reform process; in the case of the SGP, by placing all hopes on improved national fiscal rules and institutions. Such an approach may have been the only possible solution within the existing level of political integration. In other words, input and output legitimacy constraints appear to have placed a cap on the alternatives for governance reform, assuming that this could only occur through empowering the Member States to act individually – even in cases where EU-wide solutions, also in the form of a stronger coordination at the European level, would have been preferable. However, compared to a political setting of deeper integration, the 'renationalisation' of fiscal and structural policy was largely suboptimal and a second-best solution.

As for the proposals of the European Commission (2010) for strengthening the economic governance framework in response to the financial crisis that started in 2007, these reforms are constrained by the boundaries set by the current level of political integration; boundaries that may prevent necessary institutional steps that have become even more urgent in the light of the crisis itself. As shown in this section, an estimation of this 'political premium' on economic performance is difficult to derive precisely, but can be significant, as the Greek sovereign debt crisis of May 2010 illustrated.

4. CONCLUSION

Our conceptual framework illustrates that further integration towards a deep political union in the EU is linked to economic performance. While marginal improvements in the EU's and euro area's economic performance can take place within the existing institutional framework, further political integration is presented as a condition for facilitating the appropriate institutional frameworks and policy choices which would allow, ceteris paribus, for better economic performance and an overall enhanced provision of SEES for Europe in a globalised world.

The conceptual framework is based on the economic institutionalist account of the process of European integration. Institutions determine (economic) performance in the long run. The process of EU integration is about the evolution of EU and national institutions. Through the ways in which input and output legitimacy are centrally linked to the process of integration, the degree of political integration sets limits on the form of economic and political institutions as well as on the overall quality of governance and, thereby, on the attainability of better policy outcomes. Deeper political union would allow to adapt and innovate European governance so that over time more effective solutions would be found that currently remain 'out of reach' for the EU polity.

Empirical grounding for our proposition and conceptual framework is provided through an assessment of the functioning of the two main pillars of EU economic governance, the SGP and the Lisbon Strategy. Both examples show that deeper political integration would allow adaptation and improvement of the institutional design of economic governance. This is required in a context of global complexity and change driven by technological innovation and not least in times of crisis and in the light of geopolitical changes to which Europe will need to stand up. Our expectation with regard to political union is not that favourable adaptation would immediately occur, but that at least the possibility for institutional change would exist and ultimately be put to good use.

The conceptual links advanced herein point to the need for further European integration at the level of the EU, or among an avant-garde of Member States, in order to improve European socio-economic performance. This assessment suggests that any shortfall in economic performance, in conjunction with the perceived legitimacy of the European level of governance, relates to the opportunity cost of leaving integration incomplete. Facing major challenges such as the latest crisis, continued globalisation, climate change, demographic ageing, and relative shifts in geopolitical power, the EU should no longer be viewing deep political union as some kind of federalist ideal but rather as an economic imperative.

NOTES

1. The opinions expressed in this paper are those of the authors and do not necessarily reflect those of the European Central Bank or of the German Federal Ministry of Finance. Earlier versions of this paper were presented at the International Conference on 'The Economic Crisis and the Process of European Integration', organised by the University of Antwerpen and the Institute of European Studies of the Free University of Brussels (Brussels, 2 June 2010); at the International Conference on 'The Political and Economic Consequences of European Monetary Integration' (University of Victoria, B.C. Canada, 18-19 August 2005), as well as at the VIII Villa Mondragone International Economic Seminar on 'Europe – a new

economic agenda?' (Rome, 26/27 June 2006). The authors would like to thank participants at all three events for their comments.

2. On the metaphor of the half-way house, see Ian Begg (1995) who uses the concept in the context of a regional integration project that finds itself in a semi-integrated institutional and market framework.
3. Additionally, there might be external reasons for reduced state effectiveness (related to globalisation, for example). To the extent that this is true, the effectiveness that is regained at the European level could even be seen as turning integration into the 'rescue of the nation state' (Milward, 1992).
4. See Börzel (2004) who suggests that the EU corresponds rather closely to the model of cooperative federalism and finds itself in a double legitimacy trap in which declining problem solving capacity (output legitimacy) can no longer compensate for the lack of democratic participation and accountability (input legitimacy); on the two types of legitimacy, see below.
5. See also the application of these principles in the European context by Collignon (2003).
6. See also Persson and Tabellini (1992) who provide empirical evidence that the most promising explanation of why policy choices differ systematically across countries (which explains why countries grow at different rates), is different political incentives and different political institutions.
7. The discourse focuses on the euro-area because political union seems unthinkable for countries that prefer not to (or are themselves not yet able to) join monetary union as a first step.
8. See, for example, Begg et al. (1993) who make this point about accountability in particular. Accountability in turn is part of the broader concept of input legitimacy.
9. Along these lines, see Collignon (2003) who shows that legitimacy and efficiency may both depend on the scope of the institutional framework. Cf. also the argumentation by Ioannou and Niemann (2004) with reference to the economic policy coordination framework in general, and Enderlein et al. (2005) who make a similar argument with regard to the legitimacy constraints on the possible institutional reform of the EU budget.
10. In the area of international economic relations see, for example, Bini-Smaghi (2006) and Sapir (2007).
11. The concept of a politically caused 'deficit bias' was developed by Buchanan (1977). Beetsma (1999), among others, have argued that this deficit bias is enhanced in a monetary union due to externality effects.
12. See European Commission (COM (2005) 24, SEC (2005) 192, SEC (2005) 193), and European Council (2005).
13. As Tabellini and Wyplosz suggested in 2004, 'all in all, the case for the centralisation of supply side policies is weak.'
14. Tabellini and Wyplosz (2004, p. 39).
15. Kok (2004, p. 42-43); own italics emphasising the political dimension in national public debate of the EU governance framework for structural reform.
16. The Sapir report of 2003, for example, had called for a much higher concentration of EU budget resources on Research and Development (R&D).
17. European Commission, SEC (2005) 160, of 28 January 2005, p. 49.

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