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The assignment principle and EU economic policy

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SUMMARY

The EU, suffering from economic weakness and political malaise, is in a period of reflection on institutional matters. This paper offers the following view on the economic governance of the EU: First, while the economic performance of the EU has been weak for quite some time, it is also characterized by considerable diversity. There are significant differences in the economic and social performance of member states, differences which seem to be associated with the varying roles of the public sector and labour market institutions (section 1). Second, the EU system of economic governance is based on principles of subsidiarity and assignment (as defined below) and it can be regarded as largely successful (section 2). Problems are confounded rather than resolved when the two principles are disregarded or compromised, as is the case with the Lisbon process (section 3) and with endeavours at macroeconomic policy coordination (section 4). The roots of the economic weakness of the EU are not in lack of action at the Community level or faults in the EU system of economic governance. Instead, the blame must be on governments unwilling or unable to reform their economies, to adapt labour markets and public sectors to changing circumstances such as technological change, globalization and aging populations. There is little that can be done about this at the EU level, though more emphasis on multilateral surveillance and peer pressure could help to shape policy debate and enhance a fruitful process of mutual learning. Coordination at the Community level, while a popular part of EU rhetorics, risks confusing responsibilities and shifting blame to the Community for matters in which it has no real powers.

1 INSTITUTIONAL DIVERSITY AND PERFORMANCE

Economic growth has been weak in the EU for quite some time now. Catching-up relative to the US came to an end at the time of the first oil crisis. Growth of GDP has been particularly slow, as compared to the US, in the 1990s and in this decade. The remarkably weak economic performance of Europe has undoubtedly contributed significantly to the present political malaise in the EU ("It's the economy – stupid"). Notably the big member states on the continent have faced a prolonged economic stand-still with low growth and high unemployment as well as big budget deficits, while a number of smaller economies have performed much better.

In fact, Europe is a continent of great diversity. It is a patchwork of independent nation states, some with a long history and others of more recent origin, a few large and many small, some rich and others less affluent, all with their particular economic structure. These differences need not pose any major problems for economic policy in the EU. The transmission mechanism of the monetary policy of the ECB may differ as between countries, and the benefits of a well-functioning internal market may accrue to different agents and sectors depending on country-specific circumstances, but such national idiosyncrasies do not undermine the rationale of the common policies.

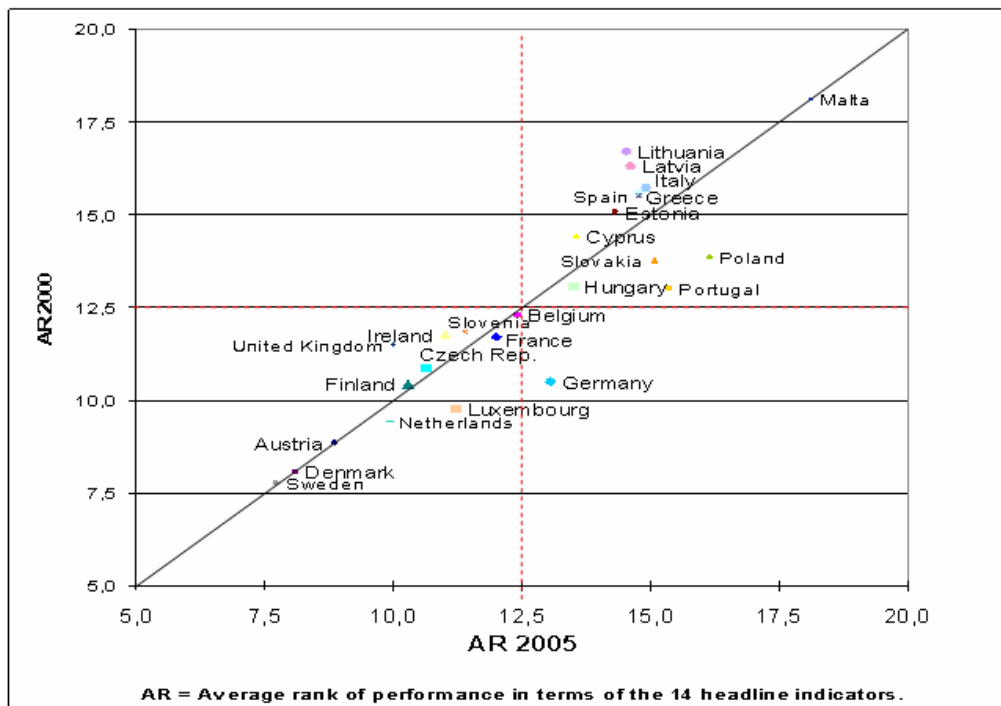
The diversity of EU member states is more policy-relevant when it relates to institutions, notably the public sector and labour market institutions. While all EU countries have large public sectors in international comparison, member states still differ significantly with regard to the scope of the tasks assigned to the state, the local authorities and the social security system. Labour market institutions also differ considerably: some member states rely on strict legislative regulation of labour markets, others leave more to trade unions and employer associations and/or workers and firms. These differences have important consequences for social and labour market policies and for the role that policy cooperation at the EU level can play. In the Annex it is shown that the 15 "old" member states can be neatly classified according to these two institutional dimensions, resulting in the four familiar "clusters" of the continental (Germany, France, Austria, BeNeLux), the Anglo-Saxon (UK, Ireland), the Mediterranean (Italy, Spain, Portugal, Greece) and the Nordic group (Denmark, Sweden, Finland).

It is interesting to observe that these "social models" perform quite differently in a number of policy-relevant areas, including those covered by the Lisbon process. As part of that process, the Eurostat regularly produces a number of structural indicators based on comparable figures. The Council and the

Commission have agreed that 14 of these, the "headline indicators", should be given particular prominence when assessing progress. While each of these indicators would merit separate attention, figure 1 below shows only the aggregate performance of member states across all 14 indicators in terms of their average ranking in 2000 and 2005. This is a crude "beauty contest", but the cross-country comparison summarizes a lot of information and it allows some pertinent observations.

First, performance in terms of the Lisbon indicators seems to have a close relationship to the institutional differences. The Nordic countries are top performers in 2000 as well as 2005, closely followed by the Anglo-Saxon countries, which have also improved their relative position. The continental group, with the exception of Austria, are mostly close to the Community average and their relative position has been deteriorating. Finally, the Mediterranean group performs weakly.

Figure 1 Lisbon performance.



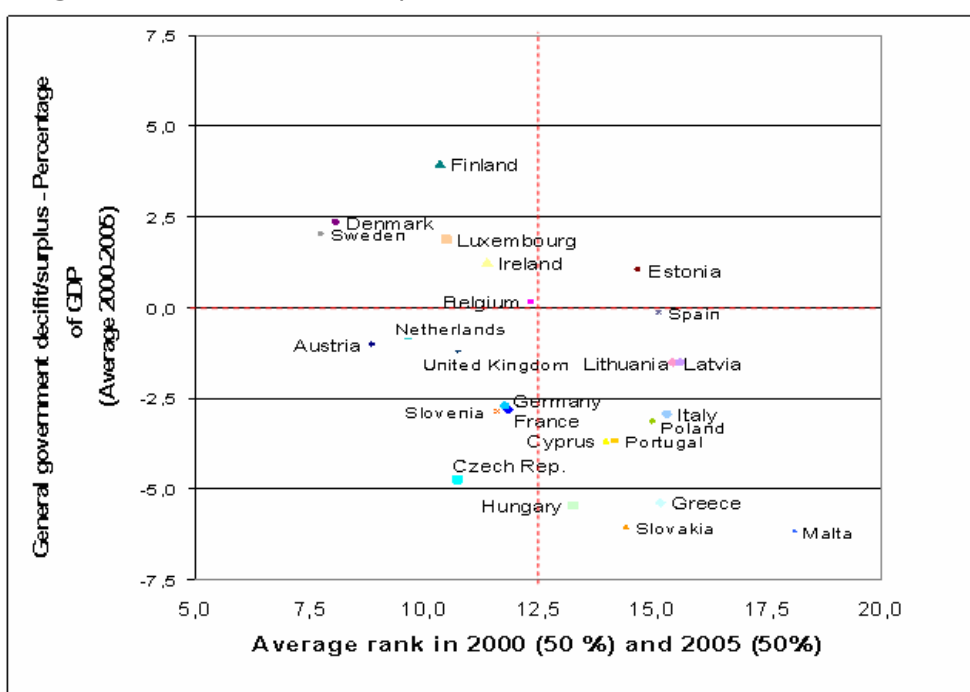
Source: Eurostat.

Second, structural performance changes only slowly; the average rank of member states changed quite little as between 2000 and 2005, only Germany having a rank above average in 2000 but below average in 2005. Member states improving their performance by 2005 as compared to 2000 include notably the

UK and Ireland, but also Spain, Greece and Italy, from low levels, as well as all the new member states except Poland, Hungary and Slovakia. Member states with a worsening performance include Netherlands, Luxembourg, France and Portugal (and notably Germany).

A third observation, illustrated in figure 2, is that the clusters of countries differ not only with regard to their performance in terms of the Lisbon process but in the domain of macroeconomic policy as well. In particular, the Nordic countries have relatively strong general government financial positions, as has Ireland, while budget deficits have been considerable in most continental and Mediterranean countries.

Figure 2 Lisbon and fiscal positions



Source: Eurostat.

As noted above, this cross-comparison is crude; there is no obvious reason to focus on the (unweighted) average rank in terms of the headline indicators. However, the differences between member states are compatible with the view set forth in Sapir (2005), according to which the continental and Mediterranean countries could usefully reflect on the policies and performance of the other two groups. The data reproduced in figures 4 and 5 in the Annex give further illustration of the differences between the groups in terms of economic efficiency and social equity.

Given the deep roots and wide ramifications of the institutional differences, there obviously is not much of a case for action at the Community level, and certainly not for harmonization of social and labour market policies. Neither is there (fortunately) any real need for Community action, as the cross-border spillovers of labour market behaviour and most public sector activities are quite limited. Also, key principles of governance caution against Community involvement in matters of national competence.

2 PRINCIPLES OF GOVERNANCE

The EU is run by its member states and institutions within a multi-method system of governance. In the area of economic policy, the key actors are the Commission, the Council, the European Council, the European Parliament, the European Central bank (ECB) and the eurogroup, in addition to the member states. Methods employed include the "Community method" or legislative codecision by the Council and the Parliament, EU programmes included in the Community budget, delegation of power in specific areas to particular institution, such as monetary policy to the ECB and competition policy to the Commission, and the multifaceted coordination method. Obviously, this framework is somewhat complex. Arguably, it is also sophisticated and to some extent successful in reconciling the conflicting requirements that governance in a multilevel decision-making system is confronted with. The principles of subsidiarity and (its close relative) assignment are of particular importance for the functioning of this framework.

There is wide agreement that the treaty-based principle of subsidiarity is, or should be, the very foundation of the system of governance in the EU, the guiding principle for institutional design as well as policy implementation². Policy functions should be allocated to the lowest level capable of dealing adequately with the problem at hand, because the quality of information and therefore of decisions is likely to be superior and errors more easily rectified when decisions are taken close to those affected by them. Needless to say, no policy action should be envisaged unless it has a clear rationale in the form of some "market failure". Also, and more pertinent in the present context, policy issues should be brought to the EU level only if their rationale has some important cross-border dimension, otherwise they should be left for member states. Furthermore, policy action at the EU level need not be supranational in character if effective cooperation of member states can be expected on a voluntary basis. In other words, the EU should act only where it is badly needed – because of significant

² For discussions of EU governance in general and the subsidiarity principle in particular see, e.g., EEAG (2003), Ederveen & Pelkmans (2006), Korkman (2005) or Sapir (2004).

cross-border spillovers – and then in as soft a manner as possible, an aspect referred to in the treaty as the “principle of proportionality”.

The (vertical) principle of subsidiarity is complemented by the (horizontal) principle of assignment, which recommends that there be a clear allocation of roles and responsibilities as between different actors. Assignment of policy functions allows the virtue of simplicity and transparency, and it should pave the way for accountability and thereby legitimacy. Specialization may also enhance professional competence of policy authorities. As emphasized originally by Mundell (1963), overall coherence of policies should be ensured in spite of decentralization as long as instruments are assigned to targets on the basis of their (relative) effectiveness.

The EMU indeed embodies a macroeconomic policy regime with a clear division of tasks as between the central bank and governments. The ECB is in charge of monetary policy, is granted strong independence, and is instructed by the treaty to safeguard price stability (similarly for the central banks of member states outside the euro area). Governments are free to pursue fiscal policies according to their national interests, but subject to the Stability and Growth Pact (SGP) and certain treaty safeguards of the independence of the ECB.

The microeconomic policy regime consists of the internal market, the economic core of the EU, and its support policies in the areas of competition, state aid and trade. The internal market draws heavily on the Community method with well-defined roles for the Commission, the Council and the Parliament, and extensive powers are delegated to the Commission for handling the support policies. The allocation of competence between member states and the Community seems largely in conformity with the subsidiarity principle, and the Community and delegation methods endow the microeconomic policy regime with reasonable efficiency and accountability as far as action at the EU level is concerned.

What about the need for coordination in order to ensure overall policy coherence in a context of multiple actors? Stronger policy coordination is often called for in EU policy documents, and occasionally by academic economists. Such coordination may amount to exchange of information and policy dialogue with a view to multilateral surveillance and peer pressure. Coordination in this sense is, or should be, unproblematic and potentially useful (though of limited significance).

However, coordination may also be more ambitious by setting common or national targets or by aiming at mutual agreement on concerted or discretionary action by different authorities. While such coordination could potentially improve the policy outcome, it raises a lot of difficulties; it would be extremely complicated and time consuming, involving governments of member states,

Community bodies as well as national parliaments. Also, it might blur (even if it does not violate) the assignment principle and thereby undermine the simplicity and transparency of the regime. It is therefore actually a great virtue of the EU policy regime that it largely does away with the need for discretionary coordination. As noted above, overall coherence of policies can still be achieved if the assignment is right and all actors do their part. Practical experience suggests that EU level coordination is difficult and risks resulting in a process with heavy bureaucracy, poor efficiency and weak accountability.

3 THE LISBON CONDRUM

A conundrum is a puzzling question or a riddle, a complex and possibly unsolvable problem (the Wikipedia). Making success of the Lisbon process is indeed an intricate challenge; the Commission and successive EU presidencies have tried various formulas for its implementation, yet the impression remains one of failure. The process is marred by problems of governance, amplified by the institutional diversity within the union.

The Lisbon process is based on the vision that technological change, globalization and aging populations call for structural reform with a view to enhancing flexibility, competition and dynamism. The European Council defined the strategic goal of the process as that of making Europe by 2010 "the most competitive and dynamic knowledge-based economy in the world capable of sustainable economic growth and greater social cohesions".

The Lisbon programme covers both the EU and member state levels, with decisions at the EU level being implemented through the Community budget or Community legislation. Particular emphasis has been on action to foster R&D. As noted by Pisani-Ferry (2006), there are cross-border spillovers in such activities, though the heterogeneity of the union must be taken into account. It might be added that this heterogeneity also makes it extremely difficult to agree on any substantial expansion of investment in R&D through the Community budget. Other key areas for action by member states include the labour market and education, financial services, taxes and social security.

There has been a strong tendency towards proliferation of the Lisbon agenda, a tendency only partly checked by the emphasis on streamlining of the mid-term review in 2005. The tendency towards escalation in terms of objectives and proposed action is a consequence of sector rivalry, each Council formation wishing to get its perspective and interests endorsed by the European Council. Given the lack of an effective mechanism of coordination (a supposed function of the General Affairs Council, which the ministers concerned are unable or

unwilling to fulfil), an abundance of recommendations is almost inevitably accepted, implying a risk for inconsistencies and lack of focus.

The method of the Lisbon process, the "open method of coordination, involves reporting by member states and the Community with a view to monitoring developments in relation to benchmarks or (non-binding) national and/or Community level targets. Originally the Lisbon process relied extensively on cross-country comparisons and peer pressure, and the Kok-report in 2004 recommended further strengthening the use of "naming, shaming and faming". However, the big member states disliked the criticism that they were subject to through such comparisons. They asked for a shift in focus such that member states are compared not to each other but rather to the objectives that they have themselves set in their "national reform programmes". This (regrettable) change in focus, which was claimed to be desirable as a way of strengthening "national ownership", was implemented through the mid-term review in 2005³.

Experience so far suggests that the Lisbon process has little effect on policy action in member states. It has led to an escalation of bureaucratic procedures, both in member states and at the Community level, producing lots of reports with lofty rhetorics, the final result being a set of carefully drafted but unexciting conclusions of the European Council in its spring meeting. The Lisbon process seems almost totally dissociated from the political reality in member states and has generated little in terms of genuine commitment to concrete action.

The difficulties of the Lisbon process should come as no surprise. It deals with issues of national competence at the Community level and thereby risks blurring the allocation of responsibilities. It disposes of no instrument for action of its own, its procedures are inefficient and complex, and there is no real accountability: citizens in member states do not know, nor do they care about the Lisbon process. After all, governments of member states are accountable to their citizens, not to the Commission or to governments of other member states.

Given these difficulties, why was the Lisbon process adopted in the first place? Arguably this happened because of a number of (mainly bad) reasons. Governments wanted to demonstrate that they care – also in their deliberations at the EU level – about those issues, such as jobs and social security, which are close to the hearth of ordinary citizens. Some member states saw it as an opportunity to preach the virtues of economic reform with a liberal bent, others thought of it as an embryo for a more social Europe. The Commission hoped to extend its influence in domains of national competence, and national officials from various ministries were only too happy to compete for influencing the agenda of the European Council.

³ This point is stressed in Pisani-Ferry & Sapir (2006).

Should the Lisbon process be discarded? No, but it should be reshaped so as to put emphasis on cross-country comparisons and peer pressure with a view to encouraging mutual learning of member states. Such multilateral surveillance has proven its usefulness in organisations such as the OECD and the IMF. Admittedly, cross-country comparisons of structural policies are fraught with difficulties. However, such comparisons may give useful impulses to national authorities and encourage them to examine their policies in the light of alternatives. There is considerable potential for mutual learning in member states as the fundamental values are the same while the institutional set-up is often different.

4 THE SGP DILEMMA AND FISCAL POLICY COORDINATION

The Stability and Growth Pact (SGP) obliges member states to aim at a medium-term budgetary objective compatible with long-term sustainability of public finances and to avoid excessive budget deficits. The pact is not about (discretionary) coordination but amounts to an institutionalized and particularly strong form of multilateral surveillance, combined with pressure for a partial harmonization of budget policies (the ceiling for acceptable deficits). The SGP was reformed in 2005 in the light of its failure to impose budget discipline on France and Germany in late 2003.

While it may be early to evaluate the reformed SGP, there is arguably little reason to expect it to play any major role for fiscal policies in the euro area. In fact, efforts at imposing national budget discipline through a Community framework seem to face a difficult dilemma:

- In its original version (the "Waigel version") the SGP was supposedly based on strict rules and a quasi-automatic sanction mechanism for breaching the deficit ceiling. This did not work because the rule was too simplistic; some discretion is needed for economic and political reasons. The reformed pact is more sophisticated and flexible but also quite complex. It gives considerable room for discretion, and experience suggests that politicians tend to exploit discretion to the detriment of discipline.
- A third option would be to delegate powers in budgetary policy to expert committees, in analogy with the operation of independent central banks. However, the national budget is a complex set of instruments and associated with distributional issues of great political significance.

There is no way to ensure national budget discipline by Community measures, such as strict rules, agreed decisions on discretionary action or delegation of powers. As with the Lisbon process, the problem is that the Community is unable to act effectively in areas that are essentially national competence. There is a common interest in the maintenance of sufficient budgetary discipline, as unsustainable budget deficits ultimately have problematic cross-border consequences, yet the national budget is also of unique importance as a vehicle for asserting national sovereignty. Governments of member states run, and must be expected to run, fiscal policy largely as they deem appropriate from their own point of view and in the interest of the citizens to whom they are accountable. Also, experience so far does not suggest that budget deficits, even if they violate the stipulated ceiling, need lead to high interest rates or pronounced weakness of the euro.

Nevertheless, the SGP can and should play a useful role by supporting finance ministers in making the case for fiscal consolidation and sound public finances. Its practical implementation could benefit from stronger peer pressure if the Commission were to calculate and publicize indicators of the fiscal sustainability of member states.

The monthly meetings of the eurogroup are a highly useful forum for exchange of information and policy dialogue. It is occasionally claimed that the euro area should have much higher ambitions for macroeconomic policy cooperation so as to achieve a better policy mix⁴. For instance, joint commitments and efforts by all member states of the euro area to pursue fiscal consolidation could pave the way for an easing of monetary policy and/or influence the external value of the euro. Similarly, growth prospects could be enhanced by concerted action in the area of structural reform, which is often associated with short term pain and long term gain, in combination with a more accommodating macroeconomic policy stance. Thus, it is argued, there is a need for stronger economic policy coordination involving, for instance, meetings of the eurogroup with participation also of prime ministers, or even for a "gouvernement économique" at the Community level.

There is no doubt that coordination could (in theory) improve the outcome of policy action. However, the case for macroeconomic policy coordination is not a strong one, as the cross-border effects of fiscal policy are rather limited. Fiscal expansion in one member state may have a positive effect on demand in neighbour countries through trade, but a negative effect by exerting upward pressure on the euro-area interest rate. In the area of structural policy it is similarly difficult to find obvious cases of significant cross-border spillovers calling for policy coordination at the Community level. Reform efforts in one

⁴ See, e.g., Pisani-Ferry (2006).

member state may benefit neighbours by lowering the area-wide inflation rate, but could harm neighbour states through effects on competitiveness. The size and even sign of the cross-border effects might vary according to a number of circumstances. In all, policy assignment may in principle be suboptimal but has the great attraction of simplicity and transparency. The ECB has grounds for suspecting that policy coordination would confuse responsibilities and give governments an excuse for fiscal inaction. The practical difficulties of policy coordination involving multiple actors (at several levels) are such that the case for (discretionary) policy coordination needs to be very strong indeed for such efforts to be justified.

5 CONCLUDING COMMENTS

The EU has a distinct policy regime with clear micro- and macroeconomic parts, based on the subsidiarity and assignment principles. This regime is basically sound, though there is much scope for improving the internal market and for using the Community budget more effectively in areas where market failures have a significant cross-border dimension, while reducing the amounts spent on regional aid and the CAP.

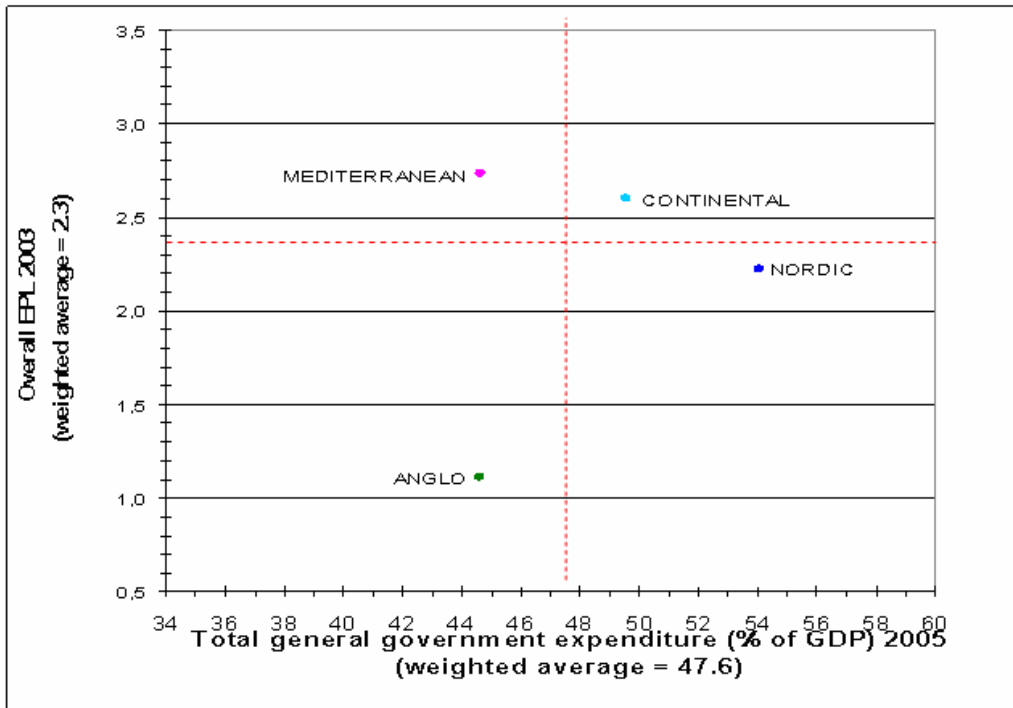
Much time is spent in the EU on policy coordination activities, but these are not at the heart of the regime and (it is argued above) their rationale and effectiveness is open to doubt. Clearly, the benefits of the EU policy regime can be reaped fully only if member states face up to their responsibilities through appropriate national policies. And regrettably, lack of action in key areas of national competence is a main reason for the stagnation that much of Europe has been experiencing. Yet, there is not necessarily all that much that can be done about this at the Community level through policy coordination.

At best, Community coordination may enhance mutual learning through a process of multilateral surveillance. Such cooperation should be descriptive rather than normative (except for the SGP), it should stress streamlining, and it should avoid creating excessive and unjustified expectations. At worst, Community coordination degenerates into an ever-escalating bureaucratic exercise, produces meaningless rhetorics with empty promises ("talk is cheap"), and diminishes the transparency of the policy regime. It can also contribute to bringing the EU into disrepute by making it a scapegoat, the perceived origin of "ultraliberalism" in some countries and of excessive interventionism in others. This is a pity and unfair because surely it is not the Community or its system of governance that is the source of the economic problems in the EU.

ANNEX: SOCIAL MODELS IN THE EU FAMILY

The relevance of institutional considerations in cross-country comparisons is widely recognized; they were the basis for the typology originally set out by Esping-Andersen (1990) and recently discussed by Huber & Stephens (2005) and Sapir (2005). A crude but useful way of illustrating the typology is the two-dimensional scheme set out in figure 3, with the degree of government regulation of labour markets (as proxied by the OECD "Employment Protection Legislation Index") on the horizontal axis and the size of the public sector (public sector outlays relative to GDP) on the vertical axis. As seen in figure 3, the 15 "old" member states may be split into 4 categories of social models or welfare states based on their group-averages⁵, relative to the average for all 15.

Figure 3 Typology of social models



EPL = Employment Legislation Protection Index

Source: OECD (2003).

⁵ Figure 1 hides some individual differences. For instance, Netherlands and Austria are in some respects close to the Nordics, and Sweden regulates labour markets more tightly than its neighbours. However, the correspondence between the analytical scheme and geography is sufficient to justify the aggregation into groups as done above.

The continental model (Germany, France, Austria and BeNeLux) is characterized by tight government regulation of labour markets with a view to job protection (of "insiders", arguably at the expense of "outsiders"). The public sector is relatively large, providing a number of services (in, e.g., the education and health areas) and social security (pension and other benefits). Benefits are often earnings-related and may differ depending on branch and/or employer. For historical reasons this model is referred to as the "Bismarckian" model. It is occasionally also referred to as the "conservative", the "corporatist" or the "Christian democratic" model. As underlined by Sapir (2005), the continental model scores fairly well in terms of social equity (risk of poverty) but less so in terms of economic efficiency (measured by Sapir as the employment rate).

The Nordic model (Denmark, Sweden, Finland) has a big (even bigger) public sector but relatively light government regulation of labour markets. Public services and transfer schemes are generous and apply to all citizens on the basis of residence and/or employment. Labour markets are highly organized and negotiations between trade unions and employer associations are instrumental in determining wages and work conditions or the ways in which these are decided upon at the firm level. This model is often referred to as the "universalist" or "social democratic" or "Scandinavian" model. Recently the Nordic model has been the object of much praise as the Nordic countries seem to score well in terms of both economic efficiency and social equity (see figures 4 and 5).

The Mediterranean or South-European model (Italy, Spain, Portugal, Greece) has a smaller public sector and a tightly regulated labour market. Public services are mostly less generous (and occasionally less efficient) than in the North, and traditionally the family plays a very important role in providing security to its members, rather than the state or the municipality. The participation rate of women is low and long-term unemployment high. It is for reasons such as these that this model is not considered particularly successful in social and economic terms.

The Anglo-Saxon or West-European model (UK, Ireland) has a relatively small public sector, though its size has recently been increasing in the UK, and largely unregulated labour markets. Public services are poor and benefits often means-tested. Labour market organizations play almost no role in the UK, somewhat more of a role in Ireland. For historical reasons, the model is also referred to as the "Beveridge" model. The key actor in this "liberal" model is the individual, while the government is expected to abstain from large-scale interventions, while providing basic security and institutions backing up the market economy.

Finally, there are the 10 new member states. It is not clear whether it makes sense to speak of an East-European model, as these countries are quite

different and rapidly evolving, economically and institutionally. In terms of averages, this group is closest to the Anglo-Saxon model.

Figure 4 Employment and productivity in 2004 (EU25).

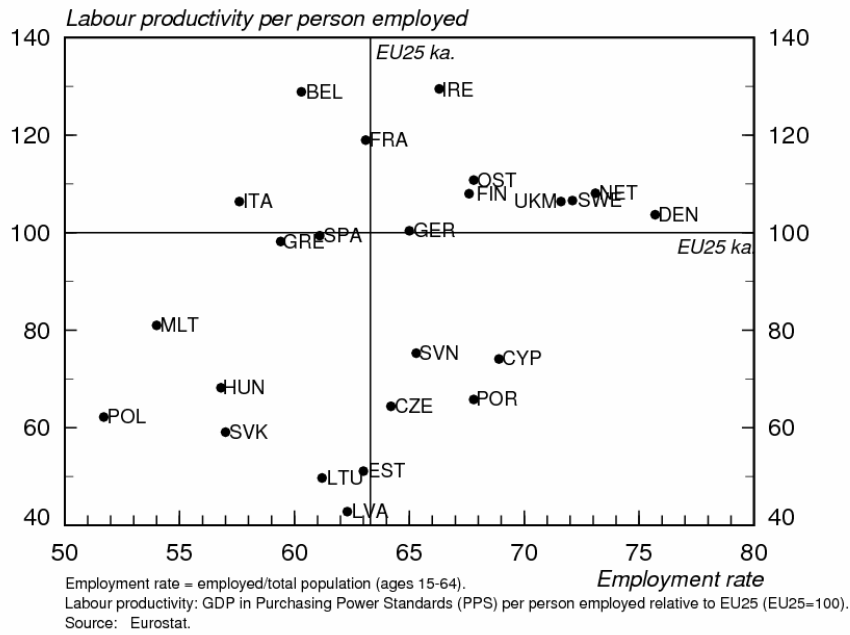
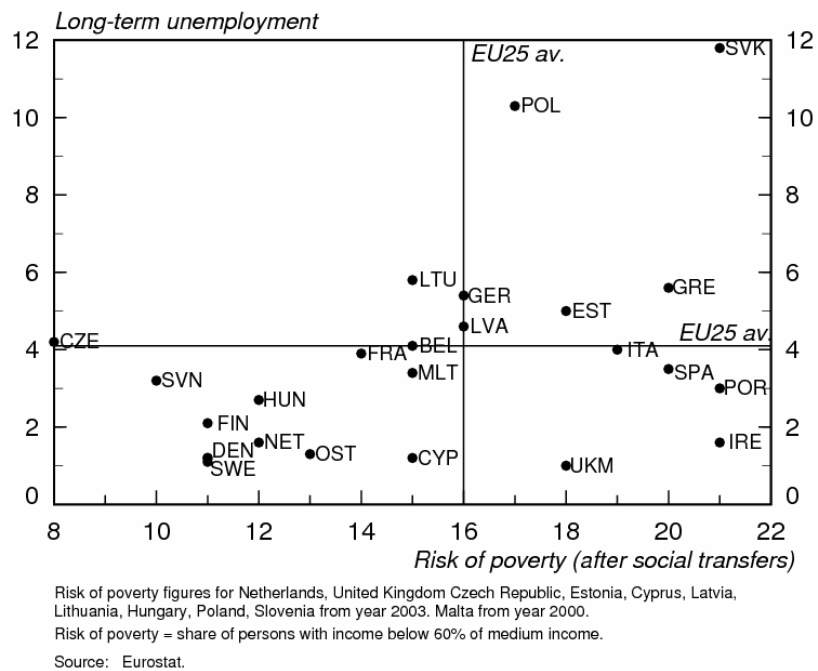


Figure 5 Social equality in 2004 (EU25).



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