Written Evidence for the European Scrutiny Committee on
Possibilities for Reinforcing the Eurozone Following the December European Council

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1. It is difficult to assess the intergovernmental agreement on 9 December on economic governance of the Eurozone before the concrete details of the proposed "fiscal compact" have been defined and adopted. As a result, I restrict my evidence to the key elements of the agreement, as set out in the Statement by the Eurozone Heads of State or Government on 9 December, which I see as:
    - a set of rules governing national budgetary discipline, which include the fact that government budgets must be balanced or in surplus, that an annual structural deficit may not exceed 0.5 per cent of nominal GDP, and that a national legal or constitutional automatic correction mechanism must be introduced in every member state;
    - a set of procedures for monitoring and enforcing budgetary discipline, which include ex-ante reporting by member states on national debt issuance plans, and an automatic sanction mechanism if a Eurozone member state's deficit exceeds 3 per cent of GDP (unless a qualified majority of Euro area member states is opposed);
    - stronger fiscal stabilisation tools, via a larger European Financial Stability Facility (EFSF) and a launch of a permanent, and treaty based, European Stability Mechanism (ESM) in July 2012, and closer coordination between EFSF/ESM lending and IMF lending to Eurozone states;
    - an agreement not to make the European Central Bank the "lender of last resort", but instead to allow the ECB to indirectly lend to governments, via loans to private banks to purchase government bonds; and
    - an agreement not to introduce Eurozone bonds, such as the plan proposed by Commission President Barroso on 22 November 2011.

2. Also, I am a political scientist, not an economist or a legal scholar, and so my evidence focusses on what I believe are the two main political weaknesses of the package: (i) the lack of credibility of the enforcement mechanism, and (ii) the lack of democratic legitimacy of decisions which will have redistributive consequences. I leave the questions of whether the proposed plan will save the Euro or usher in a decade of deflation to academic economists, and the issue of the relationship between the intergovernmental agreement amongst the 26 and the EU treaties to academic lawyers.

Lack of Credibility of Enforcement Mechanisms

3. The first problem, as I see it, is that the national budgetary discipline rules lack political credibility. *If* the intergovernmental agreement is ratified, and *if* national constitutions or basic legal provisions could be amended to introduce balanced-budget provisions (and these are big "ifs"!), I am not convinced that national electorates, governments, and spending ministries will abide by these rules. The expectation that annual structural deficits may not exceed 0.5 per cent of nominal GDP is particularly questionable. If a

national parliament approves a national budget which exceeds this threshold, there will be tremendous pressure on a national court not to strike down the budget as unconstitutional.

4. Furthermore, even if a national court did strike down a budget as breaching a balanced-budget rule, it is not clear that this would have the desired aim. Budgets are different from individual pieces of legislation, which simply fail to enter into force if they are rejected by a court under judicial review. In contrast, if a court rejects a national budget on the grounds that it would breach a balanced-budget rule, presumably the previous year's budget would continue until a new budget is adopted. And, given changes in economic circumstances, spending entitlements and tax revenues, the previous budget could well lead to a deficit of greater than 0.5 per cent of GDP anyway.

5. A similar criticism can be levied at the proposed sanctioning mechanism if a Eurozone state's budget exceeds 3 per cent of GDP. For a start, for a fine to have force it would need to be substantial, such as a particular percentage of a state's national budget. However, a substantial fine against a government which is running a deficit would be pro-cyclical, and lead to higher deficits in subsequent years.

6. In addition, the provision that a fine would be automatic unless a qualified-majority of Eurozone states vote against a proposal from the Commission means that a fine would not be automatic after all. Given the way the existing Excessive Deficit Procedure has been applied so far, and given the budgetary pressures on all the Eurozone states, I would expect a qualified-majority of states to vote not to levy a fine; and particularly if the first member state to breach the rule is one of the larger member states (who have most political weight and most numerical voting power under qualified majority voting). Then, once a fine has not been applied to one member state, the bond markets will expect the mechanism to never be applied.

Lack of Legitimacy of Decisions with Redistributive Consequences

7. An even greater concern, in my view, is the lack of political legitimacy of the whole "fiscal compact" package as it is currently designed. In a democratic society, any decision which has major redistributive consequences requires significant political legitimacy for the decision to be accepted by the net losers of the outcome (what political scientists call "losers' consent"). The problem for the Eurozone is that the proposed plan would have major redistributional consequences, both within states and between states. On one side, the restrictions on national budgets will have redistributive consequences domestically, such as cuts in national spending plans and/or higher taxes. On the other side, the bailout provisions in the EFSF and ESM as well as the sheer amount of money involved in these funds, will lead to a significant redistribution of revenues from some states (such as Germany, the Netherlands, and Finland) to other states (such as Greece, Portugal, and Ireland), at least in the short term (until the loans are repaid).

8. As long as European integration was primarily a market regulation project – involving the creation and regulation of the continental scale single market – the question of weak political legitimacy of the project could be avoid, on the grounds that creating and regulating a market only has minor direct redistributional consequences. I have

questioned this claim in the much of my research and writing over the last 15 years, on the grounds that the redistributional consequences of the single market have often been underestimated. Nevertheless, no-one can doubt that the proposed fiscal compact would be a step-change for the EU in this regard, in that decisions at the European level will now have direct consequences on national taxing and spending policies, and the distribution of wealth between different groups in society and between member states. This consequently raises the issue of the lack of legitimacy of European integration to a new level.

8. As the agreement is currently designed, neither the new constraints on national budgets (via the balanced-budget rules, European level oversight, and European sanctioned fines) nor the rules governing the transfer of resources between member states would be accepted as legitimate by citizens and national parliaments in the member states involved.

9. Specifically, the EU Commission would have a role of oversight of national budgets and have the responsibility of proposing the imposition of fines. However, the Commission is only indirectly appointed, by the European Council and the European Parliament. Despite the new Commission appointment procedure in the Treaty of Lisbon (whereby the European Council must take account of European Parliament elections when nominating a candidate for Commission President), the appointment of the Commission President is currently more akin to choosing a Pope than electing a head of a political executive! Hence, the Commission does not have a sufficiently democratic mandate to pass judgement on national budgetary discipline.

10. Eurozone Finance Ministers will be responsible for making all key economic governance decisions under the proposed fiscal compact. Eurozone Finance Ministers are more democratically legitimate than the Commission, since they are members of national governments who have won national parliamentary elections. However, while each minister might be accountable to his or her own member state this does not make him or her either individually or collectively legitimate for the EU as a whole. Put another way, why would the public or a parliament in a Eurozone state accept a majority decision against them by the Eurozone Finance Ministers (such as the imposition of a fine for breaching the 3 per cent budget deficit rule)?

11. EU legislation governing the single market must pass through the European Parliament as well as a qualified-majority in the EU Council. European Parliament elections are far from perfect, and the European Parliament is not as legitimate as most national parliaments. Nevertheless, Members of the European Parliament are independent from the Commission and national governments. As a result, EU legislation is on average more moderate and better because the European Parliament is an effective check on the other two institutions (as was seen in the passage of the so-called "six pack" of economic governance legislation through the European Parliament in 2011). However, the European Parliament is currently absent in the proposed intergovernmental structures for a fiscal compact for the Eurozone. If the European Parliament was given an oversight role of the Commission and the Eurozone Finance Ministers, this would at least add one democratic check in the proposed structure.

12. Similar criticisms can be levied at the lack of political legitimacy in the procedures for approving the transfer of funds from national treasures to the EFSF or the ESM. The current plans do not specify in any detail how national approval would work. Presumably it would be up to each member state to introduce procedures that allow for effective national parliamentary and public scrutiny of transfer of national revenues into these funds. However, it would be better – from the point of view of collective transparency and legitimacy – if the European level agreement set out in more detail the procedures that should be followed for the approval of the transfer of national revenues to the EU level. Without a agreement on at least a set of minimum procedures, there is a danger that some national governments will try to side-step national parliamentary approval of their contributions to the EFSF and ESM.

A Possible Solution

13. In general, the intergovernmental agreement of 9 December 2011 to establish a fiscal compact, a harmonization of national fiscal and other macro-economic policies, and a larger European stability mechanism might be workable from an economic point of view (although I doubt it will address the underlying uncompetitiveness of several of the periphery economies). From a political point of view, however, I believe the plan is neither credible nor legitimate. As a result, I am sceptical that it is workable or sustainable.

14. What the Eurozone needs is a proper "fiscal union", meaning an EU treasury with resources equivalent to at least 2 per cent of Eurozone GDP (for example, as proposed by Professor Charles Goodhart and several other prominent economists), the European Central Bank as the unconstrained lender of last resort, and the ability to issue Eurozone bonds (for example, following the Barroso plan). With these institutions in place, Eurozone citizens, national governments and the bond and currency markets would recognise that the Eurozone has the weapons in place to meet any major exogenous economic shocks.

15. However, such a "fiscal union" in the Eurozone would have to be balanced by far greater political integration and democratic accountability. For example, a fiscal union plan would need to be ratified in all participating member states, preferably by referendums. In addition, the EU would need a more democratically legitimacy political leadership structure, such as a directly-elected Commission President (as the CDU proposed in November 2011) or rival candidates for the Commission President before European Parliament elections.