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HOW TO IMPROVE ECONOMIC GOVERNANCE?

THE COORDINATION OF MACROECONOMIC POLICIES IN EUROPE

BY

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1. Introduction

With the Maastricht Treaty the European Union made a clear decision concerning the institutional framework underpinning the process of economic and monetary integration. On the monetary side, sovereignty was transferred at the Union level, with the creation of a European Central Bank in charge of taking decisions and implementing a single monetary policy. On the remaining aspects of economic policy, in particular budgetary policy, sovereignty was kept at the national level, although bound by coordination mechanisms and procedures.

The coordination between the member countries' economic policies is based on three pillars. First, the Stability and Growth Pact (SGP), signed by the member states in 1997, which aims at ensuring budgetary discipline and avoiding excessive deficits, as requested in the Treaty. Second, the Broad Economic Policy Guidelines (BEPGs), a document published each year in June, setting the main policy objectives for the euro area and the member countries. Third, the Eurogroup, an informal version of the Ecofin council, restricted to euro area countries, is the forum where coordination between the countries' budgetary policies, and between the latter and the single monetary policy, is expected to take place.

This paper concentrates on the Eurogroup. It examines how it has functioned since its inception and whether there are grounds to strengthen its role, in particular by formalizing its functions in the Treaty as suggested by some in the context of the Convention. The analysis looks in particular at the additional powers that could be given to the Eurogroup, and whether this would be consistent with an efficient functioning of Economic and Monetary Union (EMU).

We conclude that fiscal policy should remain largely decentralized, and there are no valid grounds for transferring powers away from member states towards the Eurogroup. Some reallocation of tasks is nevertheless desirable, but between the Ecofin Council and the Eurogroup. In particular, it could make sense to reformulate the SGP so as to apply it mainly or exclusively to EMU countries. Once this is done, the Eurogroup could acquire a formal competence in administering and implementing the SGP.

The outline of the paper is as follows. Sections 2 and 3 describe and briefly assess the current functioning of the Eurogroup. Section 4 discusses whether it would be desirable to reallocate fiscal policy tasks away from member states and towards the Eurogroup, while section 5 discusses the reallocation of tasks away from the EU (or rather the Ecofin Council) towards the Eurogroup. Section 6 concludes and formulates some recommendations.

BOX

Glossary

Ecofin: EU Council of Finance Ministers, currently at 15; Accession countries will participate as observers from the second half of 2003. Meets once a month. Sit at the main table the Finance Minister, his deputy and the country's Permanent Representative at the EU. Presided by the Finance Minister of the Country holding the Presidency.

Eurogroup: Informal group, composed of the Finance ministers of the 12 members of the euro area. The Commission and the ECB are also invited to participate. Meets the evening before the Ecofin. Sit at the table the Finance minister and his/her deputy.

Economic and Financial Committee (EFC): Committee composed of Finance Ministers and Central Bank Governors' deputies, representatives of the Commission and the ECB. Meets once a month, prior to Ecofin. Chaired by a Finance Ministries' representative for two years. Prepares the meetings of the Ecofin and Eurogroup.

Coreper: Committee of the Permanent Representatives at the European Union. In charge of formally preparing the Council of Ministers' meetings. For the Ecofin this task is largely conducted by the EFC.

BEPGs: Broad Economic Policy Guidelines. Document published in June, after endorsement by the European Council, prepared by Ecofin. Defines the main macroeconomic and structural policy guidelines for the EU, the euro area and individual countries. The Commission publishes an implementation report six months later.

2. The functioning of the Eurogroup

The Eurogroup was created in 1997, following a French proposal, in parallel with the adoption of the SGP. The intention was to create a restricted forum for dialogue with a view to strengthening the coordination of economic policies and the dialogue with the ECB. The Ecofin could not perform such functions satisfactorily because: i) it is not restricted to euro area participants; ii) its formal nature and the large number of participants would not favour frank exchanges of views; iii) the ECB would not engage in an open dialogue in such a formal body.

The proposal was initially resisted, in particular by those that feared that the new group (initially called Euro-11) could represent a threat for the independence of the newly established ECB. It was also resisted by some countries that did not initially adhere to the euro, in the fear that this would establish a strong inner core of countries that would dominate the discussions on economic policies, including in those areas, such as taxation or structural policies, that are related to the implementation of the internal market, which is an undertaking of the whole European Union.

The proposal was finally adopted, with two proviso. First, the Eurogroup would remain informal, and thus not take formal decisions. Decisions would continue to be taken only by Ecofin, where all EU countries participate. Second, the technical preparation of the Eurogroup discussions would take place mainly in the Economic and Financial Committee (EFC), and thus involve also representatives of countries outside the euro area.

The Eurogroup is composed of the Finance Ministers of euro area countries. The ECB President and the Commissioner in charge of Economic and Financial affairs are invited to participate to the meeting. The attendance is restricted to the above persons, accompanied by at most one additional person, generally the Treasury representative in the EFC. The President and Secretary of the EFC also attend. The Eurogroup is chaired by the Minister of the country holding the EU presidency. In case the Presidency is held by a non-euro area country, the Presidency is held by the country having the next Presidency.[1]

The composition and nature of the Eurogroup entail substantial differences with the Ecofin. Attendance is restricted and excludes the permanent representatives at the EU. The preparation of the meeting is exclusively in the hands of the EFC, rather than Coreper, the Committee of the permanent representatives. The Commission, not being a member, has formal no right of initiative. When it deliberates, for instance in the form of statements, the Eurogroup does so on the basis of work conducted by mainly the Presidency and the EFC. The Commission only provides input on request.

The Eurogroup typically meets on the eve of the Ecofin meeting. The items discussed are the economic and financial conditions in the euro area and in the other main partners, budgetary policies, also in light of the SGP, the mix between monetary and budgetary policies, occasionally exchange rate developments, the changeover to the euro, structural policies.

Typically, each meeting starts with a review of the economic situation, based on presentations by the President of the EFC, the Commission and the ECB. The review considers developments in the real economy, financial markets and most recent policy developments. There are regular discussions on the budgetary stance of major countries. The main lines of countries' budget policy intentions are discussed generally in July, ahead of the presentation of national budgets. A review also takes place in the fall, in parallel with budgetary discussions, and early in the year, when stability programmes are discussed and assessed. Discussions on budget policies

[1] For instance, in the second half of 2002, with Denmark holding the EU Presidency, the position of Eurogroup President was held by the Greek Finance Minister, since Greece holds the Presidency in the first semester of 2003.

also take place before the BEPGs, in May and June. The difficulties experienced in the last few years by the largest euro area countries in implementing the recommendations of the SGP increased the frequency of discussions on budget policies in the Eurogroup.

The Eurogroup discussed intensively the cases in which the implementation of the SGP have led to formal decisions. In early 2002, it discussed the Commission recommendations to give early warnings to Germany and Portugal, in view of the risks that these countries' budgets could breach the 3 per cent reference value. On that occasion, an intense discussions among ministers led to the decision not to issue an early warning. The two countries adopted firm policy commitments and the Commission withdrew its proposal of giving an early warning. The next day Ecofin ratified the Eurogroup decision.

Similar intense discussions took place on the occasion of the launch of the Excessive deficit procedure against Portugal and Germany at the end of 2002 and the early warning to France in January 2003.

The Eurogroup discussed on several occasions the interpretation of the SGP, also in light of repeated criticisms raised in public debates. In October 2002, the Eurogroup issued a statement in which it endorsed the proposal by the Commission to assess progress towards the objective of a budgetary position "close to balance or in surplus" on the basis of the cyclically adjusted deficit. The required yearly minimal reduction of the deficit should be at least 0.5 per cent of GDP. The proposal aimed at taking into account the impact of economic developments on budgetary targets and outcomes. By previously focusing only on nominal budgetary targets and deadlines for achieving balanced budgetary positions, the SGP had lost credibility since targets were consistently not achieved and postponed, partly as a result of the unexpected growth slowdown. Aiming at yearly adjustment efforts in cyclically adjusted terms is easier to monitor and avoids pro-cyclical policies.

At each Eurogroup meeting, the President of the ECB describes the latest assessments by the Governing Council of the underlying situation in the euro area and of the reasons for the latest policy decisions. The ECB stated at the first Eurogroup meeting that it did not intend to enter into ex-ante coordination, revealing policy intentions or speculating about possible trade-offs between monetary and budgetary policies, since this would jeopardise its independence. Coordination could thus only be limited, on the ECB side, to exchange of information about current developments and assessments.

In the first two years of EMU, the Eurogroup often discussed developments in the foreign exchange market, in view of the continuous depreciation of the euro. The Eurogroup issued several statements indicating that the value of the euro did not reflect underlying fundamentals and pointed to the potential for appreciation. The Eurogroup also defined the modalities for the coordination with the ECB in the monitoring of foreign exchange markets, in the dialogue with the US and Japan, especially in case of concerted intervention.

The President of the Eurogroup represents the euro area, together with the President of the ECB, at G7 meetings, when surveillance of the world economy is discussed. The preparation of these meetings takes place in the meeting of the Eurogroup preceding the G7 meeting.

Another topic that has been discussed at Eurogroup meetings is structural reforms, in light of the need to increase the growth potential of euro area economies. Comparison of experiences on issues such as tax reform, labour markets, pensions have taken place.

The output of the Eurogroup meeting is a common view on the major issues for the euro area, in particular on the implementation of the SGP, on budgetary discipline, on exchange rate developments. This shared view is presented by the President of the Eurogroup in the press conference that follows the meeting and some times in statements.

3. An Assessment

Looking at its first 4 years, the Eurogroup seems to have been successful mainly in crisis management, in particular with respect to the implementation of the SGP. Success is understood here to mean the ability of the euro area countries to express a common position.

As mentioned above, the implementation of the SGP led to several decisions on whether or not to recommend some countries to change their budgetary policies. The initial recommendation of the Commission did not always meet the consensus of the members. In January and February 2002, the proposal to give an early warning to Germany and Portugal, in view of the risks to breach the 3 per cent limit received a divided support among member states. After a long night, the agreement was reached that the two countries should make explicit policy commitments to take measures aimed at avoiding to breach the 3 per cent limit, so as to enable the Commission to withdraw its recommendation. The informal nature of the discussions was essential in making Ministers express their views openly and understand each others' positions. This could not have been possible in the Ecofin, where more than 100 people attend.

Intense discussions took place ahead of the launch of the excessive deficits procedures against Germany and Portugal and of the early warning to France, in the course of 2002 and 2003.

In the exchange of information on national budget policies, the experience has been relatively positive, as Ministers have had the occasion to explain the broad philosophy underlying their policies, the main objectives, the difficulties in implementation. This has helped understand better each other point of views. Here also, peer pressure worked well on several occasions, when countries were tempted to relax policies. For instance, after the Austrian elections, in 2000, the new Government aimed at a larger budget deficit, close to 2 per cent of GDP. The intense pressure in the Eurogroup led the Government to change direction, achieving balance in the following year.

The attempt to coordinate specific policy responses to external shocks has been rather unsatisfactory. In Versailles, in September 1999, euro area countries tried to engineer a common tax reaction to the sharp increase in oil prices. Although the intention was publicly stated, subsequent national reactions were quite different.

On broader policy response, the Eurogroup has still some difficulty to look at the overall policy stance in the euro area as a whole. The different positions across countries and the closeness to the 3 per cent reference in some cases prevents a euro area approach to budget policy. For instance, the deterioration in the environment during the Summer 2002 and the fear of a war in Iraq did not spur a decision on a common policy view. The recommendations of the BEPGs agreed in June, although clearly unrealistic, especially with respect to the commitment to achieve a budget position close to balance by 2004, were still considered formally valid in the fear that a reopening of the discussion could be interpreted as a relaxation of the SGP. Even the proposal of the Commission to postpone to 2006 the objective of close to balance did not receive consensus.

The exchange of information between the monetary and budgetary authorities has been rather scanty, given the unwillingness of the ECB to exchange views in a forward looking manner. The difficulty to commit the ECB Council, whose decisions are taken by 18 members, has been a factor. The ECB President is rarely in a position to express clear views about future monetary policy developments. As a result, the exchange of information that takes place in the Eurogroup seems weaker than the one that was taking place within individual countries between the central bank and the finance ministry before EMU.[2]

On exchange rate policy and external representation, the Eurogroup achieved progress, although not fully satisfactory. On the external value of the euro, the Eurogroup succeeded, not without some difficulty, to implement some discipline in statements by its members. This discipline would have to be tested also in a scenario in which the value of the euro strengthens.

On external representation, the rotating presidency every 6 months does not allow the President of the Eurogroup to represent a credible interlocutor for the US and Japanese counterparts. Each Eurogroup President has just one or two chances to attend G7 meetings, and so do their deputies. This is clearly insufficient to implement a continuous dialogue with counterparts and to defend in a credible manner the interests of the euro area.

[2] See Bini Smaghi, L. and C. Casini (2000), "Monetary and Fiscal Policy Co-operation: Institutions and Procedures in EMU", *Journal of Common Market Studies*, n.38 (3), pp. 375-391.

Furthermore, the Eurogroup and ECB Presidents attend only part of the G7 meeting, the one dedicated to surveillance, and is not present when other international financial issues such as crisis prevention and resolution, IMF issues, etc. are discussed. This practice, which diminishes the role of the euro area, will continue as long as the broader issues of financial stability remain in the exclusive competence of member states and as long as coordination remains largely of an informal nature. This is an issue which is also being discussed in the Convention.[3]

The Eurogroup has not performed very well in addressing issues of a more structural nature. Part of the reason is the failure to link budgetary policies and the policy mix with the need to increase the growth potential of the euro area economy through structural reforms. Some difficulties in establishing clear monitorable targets are also at the origin of the little progress made in this area. Another problem is also that Finance ministers are not the only ones responsible in their countries for structural reforms.

Overall, the Eurogroup seems to have been successful in addressing specific problems related to budgetary policies in some member states. It has been less successful in addressing area specific issues, such as the slowdown of the economy or facing an oil shock. This may partly be due to the intergovernmental nature of the organisation and the difficulty to coordinate budget policies in a situation in which starting positions differ widely. The ability to represent externally the interests of the euro area has also been rather limited.

Some proposals have been put forward to strengthen the role of the Eurogroup and to equip it better with a view to achieve its objectives. Before addressing this practical issue, we should ask which decisions should be managed at the level of the Eurogroup. There is no point in creating a new Council formation without any decision making power. At present there are no explicit decisions by the Ecofin Council that are confined exclusively to euro area countries, with the possible exception of sanctions in case of repeated excessive deficits. The current institutional set-up can be changed, if the allocation of competencies is changed in the Union. The allocation of new powers to an EuroEcofin could arise in two cases: first a transfer of powers from the member states to the euro area; second, a transfer of powers from the European Union to the euro area, for policies affecting the latter countries. These issues are examined in the next two sections.

4. Do we need more centralization of fiscal policy among EMU countries?

The theory of fiscal federalism suggests that tasks that entail large spill-over effects across localities, or large economies of scale, ought to be centralised. Decentralisation is instead efficient if heterogeneity of preferences or of information is relevant. The traditional theory of fiscal federalism

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[3] See Bini Smaghi, L. (2003), "A Single EU Seat at the IMF?", mimeo.

assumes benevolent governments, and focuses exclusively on the conflict of interest among different jurisdictions. If governments also have political concerns or face other incentive constraints, then these should be taken into account when discussing optimal task allocation.

It is useful to distinguish between three different types of fiscal policy instruments. A) The structure of taxation or specific tax rates. B) Public infrastructures and public investment projects. C) Aggregate demand management

A) The Structure of Taxation

Currently, the power to tax resides almost entirely with national and local governments. While VAT tax bases are to a large degree harmonised, all other tax bases and rates are set unilaterally by Member States. Proponents of additional centralisation argue that this is inefficient because national governments have an incentive to engage in tax competition to attract mobile factors of production, producing a race to the bottom. The validity of this argument is best discussed separately for three types of taxes: personal income taxes, taxes on income from financial assets, and corporate income taxes.

Nobody is seriously arguing that personal income taxes should be centralised. The tax base is fairly immobile, and heterogeneity of preferences and local conditions is obviously very large.

Taxes on income from financial assets are at the opposite extreme. Since financial capital is very mobile and responsive to tax incentives, tax competition in this area has the potential to be very disruptive. The best solution would be to induce member states to exchange information on assets held by individual residents of other Member States. This would enable all countries to enforce the "residence principle" of taxation (individual financial income is taxed by the country of residence, irrespective of where the financial assets are held), thus side stepping the need to centralise tax rates. But since decisions on these matters are taken by unanimity, the opposition of a few small member states has prevented reaching the first best. After long and tiresome negotiations, the EU has just agreed that 12 member states will fully exchange information on non-residents savings from January 2004. Luxembourg, Austria and Belgium (together with Switzerland and a few small off-shore tax centers) will instead levy a flat withholding tax of 15% on the income earned on non-residents savings, gradually rising to 35% from 2010 onwards. This agreement is a step in the right direction, but it illustrates the problems of unanimity rule, as opposed to decisions by qualified majority.

What about corporate income taxes? Here the conclusion is more controversial. Physical capital is clearly more mobile than labour. Hence, tax competition can induce governments to over-tax labour and under-tax capital, relative to what would be efficient and equitable. Since labour markets are far from competitive in Europe, high labour-income taxes reinforce other distortions that produce inefficiently high labour costs and high unemployment. This is the valid argument in favour of some centralisation of corporate income taxes. But there are valid counter-arguments too. Governments lacking credibility may have an incentive to over-tax capital and under-tax labor (the so called capital-levy problem). In this case, tax competition and the discipline offered by the threat of capital flight can actually help governments solve difficult commitment problems.

These considerations on task allocation have a practical implication for the design of European Institutions. How should governments decide on these matters? Advocate of more centralisation ask for more decisions by qualified majority. Opponents are in favour of the status quo, namely decisions by unanimity. The previous discussion suggests that qualified majority could be applied to indirect taxation, where tax rates are already largely harmonised, and to tax rates on the income from financial assets, to overcome the hold up problems discussed above. In all other cases, unanimity should be preserved, with one exception. In matters of corporate taxation, a standardised definition of the tax base could also be taken by majority rule. But the arguments for extending qualified majority also to corporate tax rates are weaker: heterogeneity in preferences here is bound to the high, and governments may have distorted incentives to over-tax corporate income. Concerning taxes on financial income, the need to take decisions by qualified majority would disappear if indeed the European Union were to move to the residence principle of taxation.

Finally, these matters of tax policy are not pertinent to EMU only. To the extent that there is centralisation, it should be to the level of the EU rather than the euro area.

B) Public infrastructures and public investment projects

Some public investments in transport infrastructures are classic examples of projects with large economies of scale and high spill-over effects. As such, these projects ought to be jointly planned and financed. Nevertheless, the resources absorbed by these kinds of projects are unlikely to be relevant for the economy. While the case for centralisation here is strong, it really concerns specific decisions that are best decided on a case by case basis with a careful cost-benefit analysis. Moreover, with the possible exception of TENs (Trans European Networks) the group of countries likely to be affected is typically smaller than the whole EU. Institutionalising all public investment decisions at the level of the EU seems clearly inappropriate. Again, this has nothing to do with EMU, so the EuroEcofin would have no reason to be involved a fortiori.

C) Aggregate Demand Management

Countries that joined EMU have given up monetary policy. Since the European business cycle is far from synchronised, this is already a big constraint on counter-cyclical stabilisation. They only have one tool left with which to stabilise their economies in the face of country specific shocks, namely fiscal policy. This is the simple but basic argument in favour of keeping fiscal policy largely in the hands of national governments.

What are the arguments in favour of fiscal policy coordination? Two arguments are often made. First, a coordinated fiscal policy response might be appropriate to cope with *aggregate shocks*. Second, fiscal policy coordination might be needed to internalise *spill-over effects*, to the extent that economic shocks or policy responses in one locality are felt by other localities (for instance, a fiscal expansion in times of recession undertaken in one country spills over in the form of additional demand stimulus in its trading partners).

Neither claim holds much water, however. First, careful empirical studies have always failed to find evidence of sizeable spill-over effects across countries. Fiscal policy multipliers tend to be small and imprecisely estimated, and largely confined to the domestic economy. Second, if EMU was hit by an aggregate shock that called for an aggregate fiscal policy response, each country acting in isolation would already have the incentive to react in the right direction. Such a decentralised reaction would be inadequate only to the extent that spill-over effects were relevant. Moreover, countries already have the opportunity to debate and communicate their policy intentions. Institutionalising fiscal policy coordination over and above that may be appropriate for other reasons, but not for the purpose of better calibrating aggregate demand management at the European level. On the contrary, the primary concern for task allocation here should be to preserve enough flexibility for decentralised fiscal policies.

More recently, a third argument in favour of fiscal policy coordination has been formulated.[4] It goes something like this. Even if there are no direct spillover effects of fiscal policy from one country to the other, having a common monetary policy creates links across countries. European monetary policy responds to aggregate output gaps and inflation in the euro area. Any national fiscal policy affecting such aggregate variables thus induces a monetary policy response. But the monetary policy response in turn impacts on the economies of other members of EMU, thus creating a spillover effect that calls for fiscal policy coordination. Suppose for instance that a country engages in an expansionary fiscal policy, either for opportunistic political reasons, or because it is hit by an adverse cost push shock. This increases inflation and reduces the output gap

[4] See for instance Uhlig, H. (2002), "One money, but many fiscal policies in Europe: what are the consequences?", Humboldt University working paper, Berlin.

in the euro area, thus triggering a tighter monetary policy that hurts the other countries in EMU. They too will thus be induced to expand their fiscal policy, to offset the tighter monetary policy, but this will trigger even further monetary tightening. In equilibrium, monetary policy is too tight, fiscal policy is too expansionary (or reacts too much to aggregate or national shocks), and all countries are worse off. Logically, the argument is correct, but its empirical relevance remains to be assessed.

Note that this case in favour of policy coordination suggests that, without coordination, countries are excessively reactive to shocks hitting their economies. The remedy calls for coordination (or institutions) that induce fiscal discipline or dampen discretionary fiscal policy responses, not the other way around. This argument in favour of policy coordination, therefore, contradicts the common idea that European fiscal policy is too passive and that policymakers should get together and coordinate a more aggressive discretionary response to aggregate shocks hitting their economies.

There is also another important argument against a set up that would encourage a more aggressive and coordinated discretionary fiscal policy reaction to cyclical events. It is very difficult to appropriately calibrate the timing of discretional fiscal policy decisions aiming to stabilize the economy. Because of decision making lags, implementation lags, and uncertainty over fiscal policy multipliers, active aggregate demand management could be counterproductive and de-stabilizing. Moreover, governments have political concerns, and are tempted to manipulate fiscal policy for electoral reasons. There is no guarantee that discretional fiscal policy decisions would be guided by the aim of stabilizing aggregate demand, rather than by the goal of temporarily boosting the economy ahead of the elections.[5]

The appropriate institutional set up, instead, should encourage reliance on automatic stabilizers. Countries should let their budget deficit swell automatically in downturns, and shrink in good times. Given the size of the European welfare states, these automatic fiscal policy responses would already go a long way towards stabilizing the economy in the face of business cycle fluctuations.

This takes us to the heart of the problem of fiscal policy in Europe, which is not fiscal policy coordination but the SGP. Indeed, the SGP does not allow for a full working of automatic stabilizers in all circumstances, especially in favourable cyclical developments. As currently formulated and implemented, the SGP has two features. One is the 3 per cent deficit limit. This is a very hard constraint, and the EU has set strong enforcement rules to impose the respect of this limit. The second feature is the medium run goal of budget balance. If on average countries were close to

[5] Recent empirical research estimates that on average parliamentary countries cut taxes by about ½% of GDP in a typical election year.

budget balance, then they would have ample room to let automatic stabilizers operate fully and even to enact some discretional countercyclical fiscal policy. But the EU does not have strong enforcement powers to induce countries to be close to budget balance. This asymmetry, between the inflexibility of the 3 per cent limit and the soft powers of moral suasion to achieve budget balance in the medium run, is the main source of the problem.

The SGP is needed in the first place because governments tend to be myopic. A myopic government has a tendency to remain close to the 3 percent deficit limit, postponing indefinitely the medium run goal of budget balance. This creates a problem, because it forces fiscal policy to be pro-cyclical. In good times, countries can relax and adopt loose fiscal policy since the deficit ceiling is not a binding constraint. But in bad times they are forced to enact tight fiscal policy.

In a few words, the main problem of the current institutional arrangements does not seem to be inadequate or insufficient policy coordination but rather the inability of the SGP to induce countries to keep their cyclically adjusted budgets close to balance.

Summary

To sum up, there are no strong arguments in favour of further centralisation of fiscal policy within the Eurogroup in the three areas considered, namely taxation, aggregate demand management and public investment. There are some relevant arguments that some tax policy decisions ought to be more centralised, but at the level of the EU as a whole, not only within the Eurogroup. Moreover, these arguments apply selectively to some tax rates only, not to the whole of tax policy. Current arrangements for aggregate demand management through fiscal policy are not satisfactory. But the central problem concerns the formulation and implementation of the Stability and Growth Pact, not the lack of fiscal policy coordination.

5. The transfer of powers from the EU to the euro area

Giving formal decision making powers to an EuroEcofin at the expenses of member states is not the only option. Another option would be to transfer some powers away from the EU as a whole, to give it to the euro area. Should this be done, and why?

The main reason would be one of efficiency. When the Maastricht Treaty was signed, the move to EMU was considered as involving all countries. In fact, the three-stage approach was designed in that context. Countries with a derogation, such as the UK, or not abiding by the convergence criteria, such as Greece, would remain in the second stage of EMU, while those adopting the single currency would move to the third stage. As a result, countries outside the euro area were considered to be a small temporary minority.

With enlargement, from 2004 countries outside the euro area will be a majority, 13 against 12. Even if some newcomers could join EMU in the next few years, the number of EU countries outside the euro area is bound to remain substantial. Is this a reason to reconsider the functioning of EU institutions, in particular when dealing with economic policy issues?

De facto, already today some decisions are implicitly taken by the Eurogroup and formalised the next day at the Ecofin. The decisions concerning the early warning in 2002 and in 2003 and the excessive deficits procedure were managed in the Eurogroup. Even the opinions on the Stability Programmes are discussed at the Eurogroup and ratified the next day. At present, the peculiarity can be easily dealt with, but this may be more difficult in the future, with more countries being outside the Eurogroup.

As originally formulated, the SGP should apply to all countries. This is why the Ecofin is competent for its implementation, except when sanctions are at stake. But in reality, given the link between the SGP and EMU, the practical implementation of the SGP is mainly a matter for euro area countries. Moreover, to the extent that loose fiscal deficits and lack of fiscal discipline in one member state impose negative spillovers on others, they do so only or mainly among members of EMU. The SGP has little or no rationale outside of EMU. Hence, the practice of de facto implementing the SGP through decisions of the euro countries makes sense. But the ambiguity over who is bound by the SGP and the contrast between the original formulation of the SGP and the practice of its implementation should be resolved in favour of the latter. Once this is done explicitly, a new EuroEcofin can be formally given the responsibility of administering the SGP. This would have several benefits. First, a correspondence between what is actually done and what should be done would increase transparency and foster trust in EU institutions. Second, the Commission would regain the proposal powers that it has in the Ecofin Council but not in the informal Eurogroup meetings, so that enforcement of the SGP could become more effective.

There should also be a clarification on the way stability and convergence programmes are assessed. If stability programmes are mainly a competence of euro area countries, who should be in charge of assessing convergence programmes, i.e the programmes of countries outside the euro area? Would it be acceptable that stability programmes are assessed only by euro area countries, while convergence programmes are assessed by all EU countries?

Another reason for devolving competencies from the EU to the euro area relates to external representation of the euro area. At present, the euro area is represented by the ECB President and by the President of the Eurogroup. This is however an informal arrangement, with some shortcomings in terms of continuity and effectiveness. In the general discussion taking place in the Convention, in which external representation is an important priority, formalizing the EuroEcofin, with an elected

President, would ensure continuity and consistency. The formalisation would also allow to give some role to the Commission, thereby balancing the institutional equilibrium with the Council and possibly the European Parliament.

6. Concluding remarks

There seems to be a consensus that the Eurogroup should be strengthened, and several proposals have been formulated to reach this goal.[6] One idea is to lengthen the Presidency to two years, electing the President among the members. Given the workload, this would strengthen the role of the EFC and the Commission in the support to the President and the preparation of the meetings. This would solve part of the problems of continuity of dialogue, especially with the US and Japanese authorities. A second proposal is to maintain the Eurogroup as an informal body, but to add a formal Council of the euro area members only. This could be achieved in two ways: either by creating a new Council formation, or by allowing that for some decisions related to the euro area non-euro area members of Ecofin Council would abstain. An euro area Ecofin, an EuroEcofin, would adopt decisions on euro area matters. These decisions would be taken according to the same procedure as the one used for regular council meetings, following a proposal or a recommendation by the Commission. Coreper would contribute to the preparation of EuroEcofin, together with the EFC, restricted to euro area members.

But what new tasks should the EuroEcofin take up? Unless we identify clearly what the EuroEcofin should do, there is no purpose in strengthening it as an institution. Several commentators suggest a strengthening of economic policy coordination as a generic recommendation. However, without some greater precision, there is the great risk to promote changes that would tilt the very delicate balance of responsibilities between the EU and the Member States. Members of EMU already have few instruments at their disposal to cope with national macroeconomic shocks, and one should be very careful before advocating a further transfer of fiscal powers away from member states and towards the EuroEcofin. A better idea would be to clarify that the SGP is administered and implemented by the EuroEcofin, for EMU countries only. The EuroEcofin would then take up some tasks currently performed by the Ecofin, without putting into question the allocation of competencies between the member states and the Union.

A second important issue concerns the degree of formality that the Eurogroup should have. What would be the advantages of a formal EuroEcofin? What would be its main decision making powers? The answer to these questions largely depends on how wide and how lasting will be the difference between the composition of Ecofin and that of the Eurogroup after enlargement. The

[6] See the various contributions to the Convention, for instance by the Commission of by France and Germany.

most likely scenario is that the difference between the two will diminish overtime as the newcomers become also members of the euro area. But we cannot rule out another scenario, where several countries opt to remain outside the euro, not temporarily, but in the long run. In this second scenario, the justification for having two different and formalized Ecofin councils would be much more compelling.

Finally, how important are issues of external representation and interaction with the other two major economic and monetary zones? Are the current arrangements satisfactory? Would the current shortcomings be overcome if the Eurogroup was transformed into an EuroEcofin? The answers to these questions also have important implications for how to optimally complete the design of the institutional framework of EMU.