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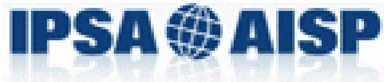

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The Three Sources of Legitimacy for European Fiscal Policy

STEFAN COLLIGNON

ABSTRACT. Fiscal policy has remained under the authority of national governments in "Euroland," while monetary policy is unified in the hands of the European Central Bank. This arrangement does not produce optimal results. This article looks at the normative foundations of fiscal policy in the European Union, by mapping the allocative function, stabilization, and redistribution policies onto three models of legitimacy: the problem-solving European Union, the communitarian model, and the European Republic.

Keywords: • Democracy • European Republic • European Union • Fiscal policy • Legitimacy

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Europe's economic governance is incomplete. This creates problems of efficiency and undermines the legitimacy of European integration. While monetary policy is under the control of the European Central Bank (ECB) and committed to price stability, nobody is in charge of stabilization policy in the broader sense, which includes internal and external equilibrium, and most notably unemployment. The interaction between monetary, fiscal, and income policies is crucial for achieving simultaneously stable prices, balanced growth, and high employment. Yet, in "Euroland" the outcome of this "policy mix" is not the result of coherent policy options. Budget decisions are decentralized and taken in the context of national constituencies. The Stability and Growth Pact (SGP) provides a set of rules stipulating how each national authority ought to behave, but the aggregate European level, which matters for monetary policy, is only the sum of 12 random processes. This means that fiscal policy cannot be used as a *policy tool*, because a random process cannot be adapted flexibly and deliberately to changing circumstances. Given that wage bargaining has remained compatible with the stability objectives of the ECB, the indeterminacy of European fiscal policy must be a key for the euro's disappointing economic performance. There are good reasons to believe that the policy mix in Euroland is suboptimal (Collignon, 2004a).

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However, this is not the topic of this article. The real problem is not so much "bad policy" or the reluctant application of collective decisions. It is institutional. While economists have intensely debated the role of fiscal policy and the interaction with monetary policy, they usually assume both to be under the control of unified and coherent actors, and analyze how these two actors optimize some objective function under given constraints. But Europe has no unified fiscal actor. Each member state has authority for its own budget policy and sets its objectives independently of others. Politically, this seems justified. Democratic legitimacy emerges from the constituencies, which elect and revoke governments as their agents. "No taxation without representation" is a founding value of democracies. Behind the issue of policy efficiency in Europe lays a more fundamental question: what are the sources of legitimacy for an integrated fiscal policy? Part of the difficulty of improving the EU's economic performance are ideological contradictions and a lack of constitutional consensus. I will focus on the normative foundations of fiscal policy in Euroland and analyze how three well-established normative models of European integration contribute to very different and often incompatible visions of the role of fiscal policy in monetary union. First, I will recall the three classical functions of public finance in the European context and then I will map them onto the normative framework of European integration.

The Classical Functions of Public Finance

Does fiscal policy matter and for what? By fiscal policy we mean decisions relating to the level of expenditure, taxes and their balances, and the evolution of these aggregates over time. To understand their impact, it is useful to refer to the classical distinction of the three functions of public finance: allocation, stabilization, and redistribution.

The Allocation Function

We call a public good anything that provides joint and non-rival utility to a group of individuals, and we distinguish two types of public good. Some require material resources for their production, for example, hospitals, railways, government bureaucracies, and so on. Others derive simply from regulations shaped by policy decisions. The allocation function deals primarily with the first; stabilization and distribution with the second. By allocating resources to different uses in accordance with consumers' preference rankings, their welfare is maximized. Notice that welfare and efficiency are both defined by the utility function (the index of individual and collective preferences over a range of applications). What counts as collective utility is a matter of consensual agreement. The statement about efficiency does not claim any particular distribution of outcomes. That is the result of the initial distribution of resources. Efficiency simply means that it is not possible to achieve greater utility with the given resources. Neoclassical economics claims that markets tend to secure optimal economic efficiency. Because European integration is based on market building by removing obstacles to trade, the allocation issue has near-constitutional status. By integrating fragmented markets, allocative gains in income and welfare can be obtained (Altomonte and Nava, 2005). Economists usually assume preferences to be exogenously given, and they silently pass over the question of how the utility index is established. With respect to private goods, this is rather unproblematic. Markets will ensure

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that individuals reveal their preferences correctly because a consumer who is not willing to pay can be excluded from transactions. Firms will allocate their resources to these preferences until marginal costs equal marginal utility. Gross domestic product (GDP) is then an appropriate indicator of welfare, and it is of little interest how private preferences are formed.

This is less obvious for public goods. Here, the supply (allocation of resources) and consumption of goods (allocation to preferences) cannot be confined to individuals who are willing to pay. Because supply and demand for public goods are not exclusive, the market mechanism fails to ensure that individuals reveal their preferences correctly. There would be no problem if all consumers had the same preference for consuming the collective good, because decisions by unanimity resemble individual choice (the representative agent model).[1] However, difficulties arise when there are heterogeneous preferences and one person's actions affect the utility of another individual. This externality breaks the link between resource allocation and the efficiency criteria of welfare. The social marginal cost and benefits of supplying a public good must include the cost and benefits of the externality. In order to re-establish the link, externalities need to be "internalized," which means a mechanism is needed whereby all those whose utility function is affected by the allocation of resources must contribute to the definition of the collective preference. This is the basic idea behind the modern concept of democracy, which Habermas (2001: 65) defines as "a political order created by the people themselves and legitimated by their opinion and will-formation, which allows the addressees of law to regard themselves at the same time as the authors of the law."

To avoid misunderstandings, let me emphasize that this internalization problem cannot be solved by decentralization or subsidiarity. The theory of fiscal federalism (Musgrave, 1959; Oates, 1972) states that if public goods can be supplied by different levels of jurisdiction, then the "highest" or most centralized level should provide the goods that service the whole population. By contrast, goods which affect only parts or groups of the population should be supplied by an authority responsive to the specific preferences of that group. In other words, the range of competences of different jurisdictions should be determined by the size of the population potentially affected by the jurisdiction's decision. The European Union has enshrined this logic as the principle of subsidiarity.

Subsidiarity makes an obvious claim. There is no need to provide snowplows to sub-Saharan Africa. But in recent years, the argument has been taken much further: the idea has emerged whereby jurisdictions are or should be defined by collective preferences, identities, or feelings of belonging to a community. It is claimed (see, for example, Alesina and Wacziarg, 1999) that local governments know best, and therefore efficient government (or, even the optimal size of countries) is determined by preference homogeneity (or to be precise, by the trade-off between preference homogeneity and economies of scale or other exogenous externalities). In essence, this approach tries to solve the externality problem by constructing a "communitarian representative agent model." If there is no unanimity on collective preferences in society, one may find it within communities.[2] This argument is too narrow because it ignores the externalities that the realization of one person's preference may cause for another. For example, if the regulation of my condominium prevents me from having wild parties, I will be frustrated. But if we decentralize on grounds that "I know best what is good for me," the desire of my neighbor to have peace and quiet may be disturbed.

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We therefore need a mechanism which permits the agreeable regulation of our common good. Decentralizing to the level of homogeneous communities will not achieve this task.

Traditionally, liberal philosophers have assigned the role of regulating common goods to government, which, according to David Hume (1978: 539), is "one of the finest and most subtle inventions imaginable." Governments internalize externalities by passing laws and regulations and by imposing taxes in order to provide resources for public goods. They optimize welfare when appropriate tax rates bring private marginal costs into line with social costs. For Adam Smith, taxing individuals was justified if it served to protect society from violence and invasion (1976: 689) and from injustice and oppression (1976: 708), because individual citizens may not be able to provide the necessary public goods.[3] This is the classical liberal argument for burden sharing in the presence of externalities. However, in this form it is too simplistic. There is no guarantee that resources will be allocated optimally to the production of public goods, even if that would improve welfare. Voluntary cooperation among potential beneficiaries alone is not sufficient. Well before Adam Smith, David Hume had already seen that *collective action problems* and time-inconsistent preferences were likely to prevent the optimal supply of collective goods and he concluded that a "government" or "political society" was needed:

> There is no quality in human nature, which causes more fatal errors in our conduct, than that which leads us to prefer whatever is present to the distant and remote, and makes us desire objects more according to their situation than their intrinsic value. Two neighbours may agree to drain a meadow, which they possess in common; because 'tis easy for them to know each other's mind; and each must perceive, that the immediate consequence of his failing in his part, is, the abandoning of the whole project. But 'tis very difficult, and indeed impossible that a thousand persons shou'd agree in any such action; it being difficult for them to concert so complicated a design, and still more difficult to execute it; while each seeks a pretext to free himself of the trouble and expense, and would lay the whole burden on others. Political society easily remedies both these inconveniences. (Hume, 1978: 538)

Thus, the existence of externalities and the need to administrate them through governments were clearly recognized by the early liberal classics of the Scottish enlightenment as part of the system of natural liberties (Musgrave, 1999). Today, the liberal discourse seems to have forgotten this fact, but the same argument applies to the need for a European political union. A political union does not necessarily imply a bureaucratic Leviathan. Although collective action problems and time inconsistency are powerful arguments for government regulation of the market economy, these do not necessarily require big government that diverts private resources. Regulating private activities by social and legal rules and norms may be enough to internalize externalities. The liberal critique of government is not about the government as such: it objects to the "excessive" allocation of resources to collective goods. Thus, government can be small and still a strong regulator. When individuals have incentives to act in contradiction to collective welfare, the public interest will need to be safeguarded by a single, unified agent, that is, by government. But such government is only legitimate if it acts as an agent for the citizens concerned.

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This poses two questions. First, what are the criteria for deciding which externalities can be regulated by rules and norms and which ones require delegation to a government? It can be shown that the rule-based regulative framework will work when the transactions between individuals are characterized by *strategic complementarities.* This notion describes the situation when the marginal utility of one agent increases if all agents jointly implement a certain policy rule (Cooper and John, 1988). Each agent will then voluntarily do what is in the public interest. For example, following traffic rules is such behavior, as my safety increases if everyone else conforms. Knowing this, I will also conform. It may still be necessary to use surveillance agents to prevent imperfect information from producing suboptimal equilibria, but, in essence, the arrangement is self-sustaining. However, this model breaks down in the case of *strategic substitutabilities.* The marginal utility of one individual would then augment if she were not following the rule, provided everyone else is actually implementing it. Strategically acting agents, who take into account what others do, will therefore tend to do the opposite of what the collective interest requires and public goods will not be provided optimally. For example, my marginal (net) utility falls if I have to pay taxes for a collective project. But if I could avoid paying and still benefit from it, while everyone else paid up, my free-riding would increase the tax burden for everyone else, but lower mine. As everyone else would like to do the same, resources are not efficiently allocated to the project. A government is therefore needed, as Hume already understood, to ensure the optimal allocation of resources to public goods. In the next section, I will argue that fiscal policy, and especially the definition of the aggregate fiscal policy stance in Euroland, is dominated by strategic substitutabilities (see also Collignon, 2003, 2004b).

A second question is how large the public sector should be. Since Adam Smith, (neo)liberals have aimed for small public sectors, but market failure and increasing externalities may push the argument in the opposite direction. As I will discuss below, the preferences for small or large public sectors are, in democracies, the result of intense and drawn out policy debates taking place between parties and among citizens within the given constitutional framework. Therefore, *constitutions and constituencies* will pre-structure policy outcomes.

Figure 1 indicates the variations in total public expenditure for some selected countries. The size and variations of the public sector are significantly greater in Europe than in the USA. Scandinavia and France prefer a public share well above 50 percent of GDP; Germany, Italy, and Europe as a whole between 45 and 50 percent; the UK just below 45 percent; and only Ireland has collective preferences that are comparable to the USA.

Preferences for the size of the public sector are specific to each nation-state. This is also apparent from Figure 2, which shows the distribution of government public expenditure for all 25 EU countries in 2005, as well as the tiny share of the European budget (less than 1 percent of EU GDP). The mean proportion of public expenditure for the EU-25 is 46.7 percent, with a minimum of 34.0 percent and a maximum of 56.6 percent. The standard deviation is 5.4 percent, but the distribution fails the normality test (the χ^2 test gives a value of 2.2923 [0.3179 p-value] and the skewness indicator is –0.589). Hence, we can conclude that there is not one uniform pattern of government expenditure in the European Union from which individual countries deviate randomly. Instead, each country determines its own allocation of resources for public goods. However, Figure 1 also

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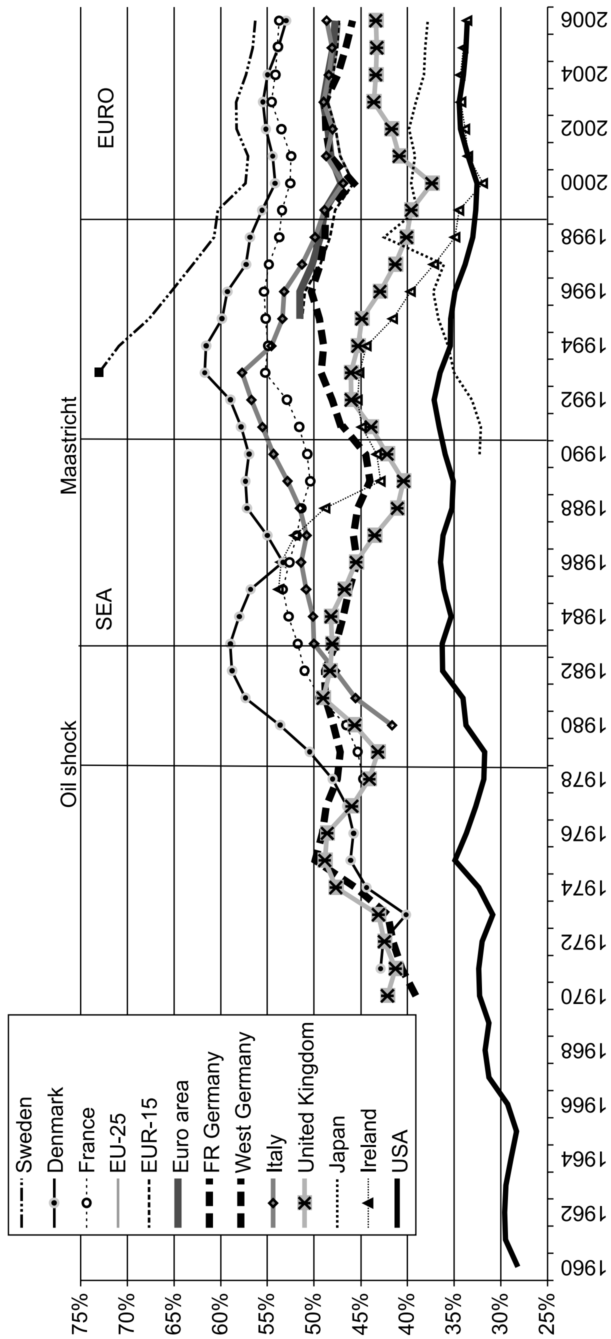

FIGURE 1. *Government Expenditure as a Share of GDP*

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reveals that, at least after signing the Maastricht Treaty in 1992, the growth of public expenditure has developed more uniformly, lagging behind GDP growth, so that the government share has fallen. This may reflect the constraining force of the Maastricht convergence criteria, for the fall in public spending as a proportion of GDP does slow down after 1999.[4]

Compared to national budgets, the share of spending for public goods provided at the European level is marginal with less than 1 percent of EU GDP. This is not likely to change significantly within the foreseeable future. In policy debates regarding the apparent failure of the Lisbon Strategy, calls have been made for increasing funds for European public goods such as research and development, public infrastructure, and so on. Such developments are fiercely resisted by governments, but even if the EU budget were to be doubled, its size would remain insignificant for stabilization purposes. However, it is important to keep in mind that there are also an increasing number of European public goods that affect all European citizens, but do not require substantial resources. These "goods" are the result of policy regulations, such as competition policy in the single market, the inflation rate, interest and exchange rates, or even unemployment in the European Monetary Union (EMU). These goods require *efficient government*, but not necessarily large shares of resources.

European integration has had far-reaching consequences for the allocation of resources in Europe. After the Keynesian era with its strong fiscal activism at the level of the nation-state, the Single European Act in 1986 represented the breakthrough of neoclassical supply-side economics, seeking to improve the efficiency, competitiveness, and growth of the European economy by improving the private allocation of resources across Europe by market integration. The "price of Non-Europe," so convincingly analyzed by Cecchini (1988), reflected the opportunity costs of misallocated resources due to obstacles and protection in intra-European trade. The realization of the single market released significant efficiency gains for the production of private goods, even if the empirical evidence is difficult to measure (Ziltener, 2004). Yet, with the emergence of a fully integrated market, the likelihood of spillover externalities and market failure at the European scale also increased. New forms of regulation were therefore required. By definition, European regulation could no longer be confined to individual nation-states. For example, the single market implied lower prices (good for consumers everywhere) and lower mark-ups due to more competition (bad for local companies). This led to the restructuring of the industrial tissue, with small companies losing out to larger ones and negative consequences for employment, but positive effects for productivity. Although the result was a more efficient allocation of resources in Europe, it also mobilized localized protectionist resistance. In order to prevent local governments from impeding economic efficiency, a European-wide system of governance was necessary. Trans-European market building required the delegation of the single market program to the European Commission. Subsequently, new policy areas, such as monetary policy and European social policy, were brought into the European domain, some by establishing federal institutions (such as the ECB) and others by intergovernmental coordination (for example, the Lisbon Strategy). But the direct provision of public goods by governments remained essentially at the nation-state level.

Although the Delors I and II packages introduced inter-regional redistribution policies, the share of EU expenditure has remained extremely limited. It is true

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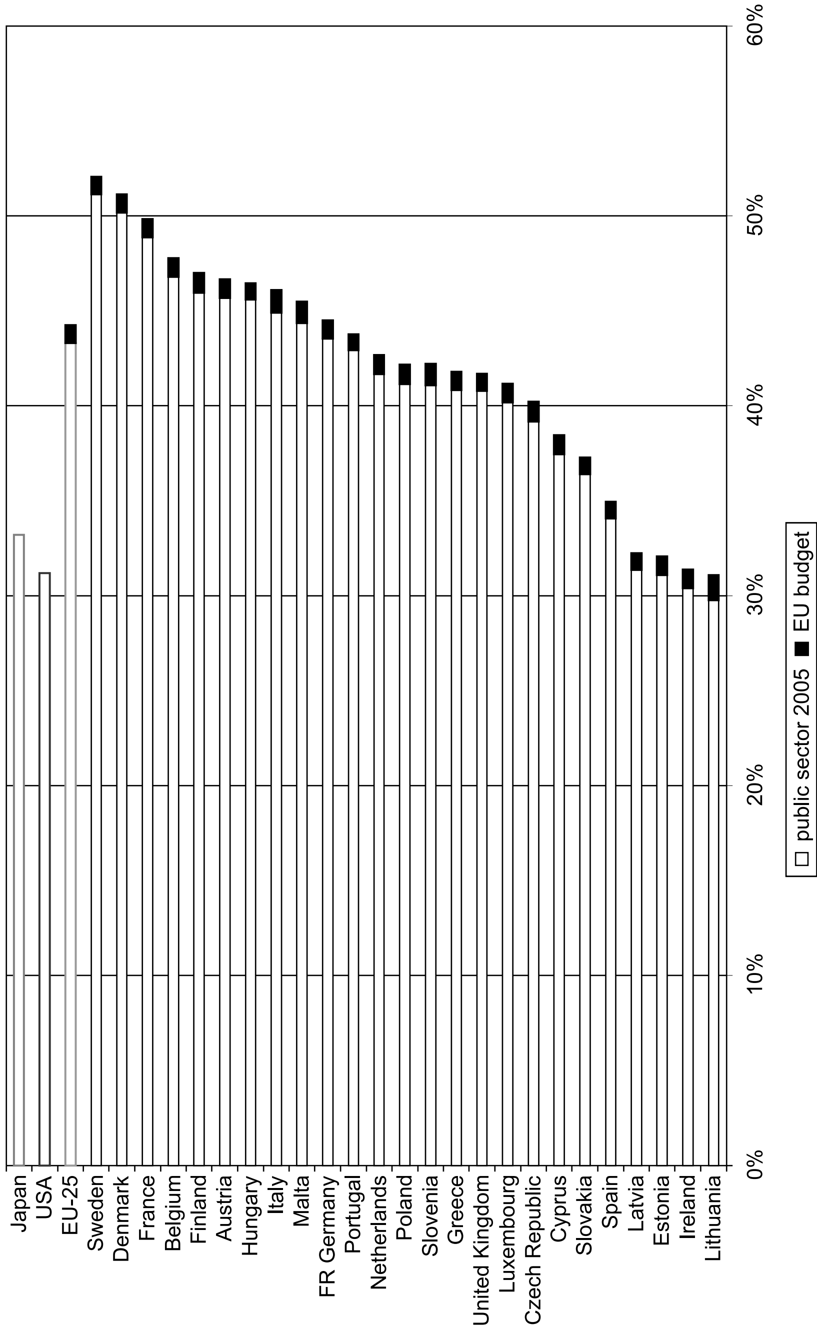

FIGURE 2. *Total Public-Sector Spending as a Percentage of GDP*

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that the total EU budget is larger than the GDP of 10 (mostly new) member states,[5] but its share of total EU GDP remains less than 1 percent. This is in stark contrast with fully developed federal states, where the central government's contribution is significantly higher. For example, central government expenditure varies in Australia, the USA, Switzerland, and Germany between 8 percent and 14 percent of GDP, and if social security is included between 18 percent and 31 percent, while state and local government only spend between 10 percent and 14 percent (Ardy, 2004). Such proportions are considered unacceptable in the European Union.

European integration, therefore, has had a paradoxical effect. On the one hand, optimizing the allocation of resources across Europe required deregulation at home, re-regulation at the European level, and the centralization of monetary policy, while the allocation of resources to public goods remained under the authority of national governments and few resources were assigned to European public goods. Yet, every euro spent by national governments adds to aggregate demand at the level of the euro area. The national allocation of resources therefore causes externalities for all euro-zone consumers that need to be internalized by aggregate stabilization policies. The theory of fiscal federalism has always insisted that the allocative function should reflect the subsidiarity principle. But the stabilization function can only operate efficiently if the definition of total expenditure (that is, by all jurisdictions) is centralized at the federal level (Musgrave, 1959). Europe's fiscal constitution begs the question: how can European Monetary Union pursue an efficient stabilization policy when legitimate expenditure at the European level is so low?

Stabilization Policy

The attempt to optimize resource allocation inevitably required a single currency as a second step (Padoa-Schioppa, 1987), and thereby turned stabilization policy into a European public good. For if the exchange rate is determined as the relative price of assets in foreign exchange markets, market volatility would continuously distort the optimal allocation of resources. An efficient single market required monetary stability. Centralizing monetary policy in the ECB was necessary in order to secure the functionality of the single market. This insight had become common knowledge among the central bankers in the Delors Committee, which prepared the Maastricht Conference. Yet, during the 1980s, different ideas also circulated in Europe. While the British government put forward market-based proposals for currency integration, rule-based approaches to monetary cooperation in the form of a European Monetary Fund and the development of the ecu as a parallel currency were also under discussion (Collignon and Schwarzer, 2002; Heisenberg, 1999). The Bundesbank insisted that, due to its discretionary nature, monetary policy needed to be centralized in a "federal" authority. From a systemic point of view, it was right. An institutional arrangement of "one market, many monies" is normatively inconsistent with a modern economy, where money serves as the hard budget constraint against which the scarcity of resources and their most efficient allocation is measured. Money cannot serve as the hard budget constraint if one market operates with several monetary standards.[6] The creation of the European Central Bank was therefore the correct answer to the transformation of the European market economy.

However, a similar argument can be made for fiscal policy as a tool for macro-economic stability. The creation of a fully integrated financial market also facilitated

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governments' borrowing. If money is to be the hard budget constraint in the economy and price stability is to be maintained, the Central Bank has to keep money scarce or, what amounts to the same thing, limit the supply of money. But an efficient capital market is defined by free access for borrowers. This implies that funds available in capital markets are a "common resource," and access to them follows the logic of strategic complementarities. Theory would therefore indicate the need for a federal fiscal authority in order to overcome the potential collective action problems (Inman and Rubinfeld, 1992).

However, before discussing the institutional issues of stabilization policy, we must ask: how relevant is fiscal policy for achieving macroeconomic stability? During the anti-Keynesian counter-revolution of the 1970s and 1980s, the idea that budget deficits could make a positive contribution to stabilization and growth fell into disrepute. For example, the Ricardian Equivalence Hypothesis (Barro, 1974) denied the Keynesian assumption that government net expenditure could compensate for shortfalls in private-sector demand. Budget policies were considered ineffective with respect to "real" economic variables, but they could cause inflation in the long run. However, if consumers do not internalize the future tax implication of current deficits (assuming "future generations will pay for them"), Ricardian Equivalence fails and budget deficits do matter for stabilization. Thus, the nature of expectation is crucial for explaining the effects of fiscal policy, although fiscal *discipline* was always seen as necessary to ensure monetary and financial stability. This could be achieved by binding fiscal rules. Institutions for the active pursuit of macroeconomic stability were not deemed necessary. Furthermore, even Keynesians had lost confidence in the efficiency of fiscal policy. The inability to find a satisfactory way of formulating discretionary fiscal policy as an implementable rule and a set of practical institutions to support that rule (especially in a regime of floating exchange rates) had made them skeptical of attempts to use discretionary fiscal policy to stabilize the business cycle (Eichenbaum, 1997: 237). The practical debate about stabilization policy therefore increasingly centered on monetary policy. However, fiscal policy has not disappeared from the agenda and in recent years a new consensus has emerged. It favors balanced budget rules, but recognizes that the operation of automatic stabilizers (changes in government revenue and expenditure that arise automatically from fluctuations in economic activity) can smooth the business cycle. Discretionary demand management is to be avoided, as automatic stabilizers introduce sufficient flexibility into rule-based policies, but fiscal policy is acceptable for supply-side purposes, such as improving the potential growth rate, covering pension liabilities, creating labor market flexibility, and so on (ECB, 2004). Thus, automatic stabilizers can contribute to the efficiency and stability of macroeconomic policy, while discretionary supply policies should reflect more fundamental collective policy choices.

Usually, the debate among economists about the conduct of appropriate macroeconomic policies assumes the institutional context of centralized budget authorities. In this case, the government defines a transparent, although not necessarily optimal (Sargent and Wallace, 1981), fiscal policy stance, which reflects intertemporal preferences in equilibrium, and monetary policy will adjust in order to preserve stability. In European Monetary Union, this argument no longer holds, as Europe's institutional arrangements do not allow the pursuit of an integrated fiscal policy. As every member state aims for its own national objectives, the aggregate European policy stance is the result of several uncoordinated processes.

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The European fiscal policy stance is, therefore, not the result of coherent strategy, but a random event.

An efficient fiscal-stabilization policy can be achieved by two institutional arrangements: a large federal budget, as in the USA, or strong binding rules, as in EMU. In the USA, a significant part of the allocation function is at state level, but the stabilization function is centralized, as the federal government provides transfer grants when tax revenue falls short of planned balanced budgets. Earlier EU documents, such as the MacDougall Report (1977), argued for large European budgets in the context of stabilized exchange rates. The Delors Report (1989: 94) still gave a prominent role to fiscal policy: "Both for the purpose of internal macroeconomic objectives and in order to be able to participate in the process of international policy coordination, the Community will require a framework for determining a coherent mix of monetary and fiscal policies." But the accent had already shifted from the European aggregate to decentralized national concerns. Fiscal policy at the European level now had to prevent the "undue appropriation of EMU savings by one country" (Delors Report, 1989: 95) and the crowding out of private savings through excessive deficits. A large "federal" budget seemed politically unacceptable (Bini-Smaghi et al., 1994). Without sufficient sources of legitimacy, Europe opted for a fiscal policy framework based on rules, rather than on federalist principles.

Yet, according to the theory of fiscal federalism, there is a dilemma. An efficient European budget would need to be small from the point of view of allocative efficiency, but large for stabilization purposes.[7] As Lamfalussy put it in the Delors Report (1989: 95): "The size of the Community budget would clearly be too small to provide for an adequate *masse de manoeuvre* for an effective macro-fiscal policy. As a result, in an EMU an appropriate aggregate fiscal policy could not be determined without impinging on the autonomy of national budgetary positions." Given that most public spending in the EU is undertaken by member-state governments (see Figure 2), the stabilization function in Euroland must work through national budgets and not through a centralized European budget. The aggregate fiscal policy stance in Euroland, which matters for monetary policy, is then simply the bookkeeping result of adding up the different national budget positions. If fiscal policy were to become a tool for macroeconomic stabilization, member states would have to coordinate their national policies, either voluntarily or under the authority of a European government.

The alternative solution to the dilemma proposed by the Maastricht Treaty was the excessive deficit procedure. Member states were free to define the amount of resources allocated to public goods, as long as they financed them by raising taxes. But excessive demand impulses (and unsustainable debt build-ups) were to be avoided by following the rule of not exceeding public borrowing by more than 3 percent of GDP. Later, this simple rule was strengthened by the Stability and Growth Pact, which stipulated the norm of balanced budgets. However, given the fact that public authorities are usually the single most important debtor in capital markets, regulating public borrowing is important, not only to prevent financial market instability, but also to maintain favorable conditions for economic growth. This logic provides a justification for the SGP. But it does not provide a solution for the collective action problem, which would require a single institution for implementation of a coherent policy strategy.

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Contrary to what is often claimed in the public debate, the problem with the SGP is not the role of automatic stabilizers, which stabilize demand through automatic tax windfalls. Indeed, if all countries balanced their cyclically adjusted budgets so that structural deficits were zero, the likelihood of exceeding the 3-percent margin would be low for all member states (Dalsgaard and De Serres, 2001). The automatic stabilizers could work as they should. The real issue is that many member states' structural deficits are not balanced. In fact, in most countries structural deficits have deteriorated since EMU started: the aggregate position has moved from 1.6 percent of GDP in 1999 to 2.5 percent in 2004 (see Figure 3), although one may argue that the SGP may have prevented a worse development. Some six out of 12 countries have cyclically adjusted deficits in excess of 2 percent of GDP, so that it is not surprising that they hit the excessive deficit limits during a period of growth stagnation.

The evolution of structural deficits reflects the unresolved issue of democratic legitimacy for fiscal policy. Without an authority that has been empowered by the European sovereign (that is, by citizens), national governments are the only institution that can claim to represent a democratic mandate. "No taxation without representation" implies here that ultimately only member-state governments may decide on budget balances, even if this causes significant externalities. The logic of collective action causes structural deficits to rise as the cost of borrowing is lowered by collective restraint, so that each member state is tempted to borrow more. A simple policy rule agreed by governments, such as the SGP, does not carry the same legitimacy as a policy mandate received from the ballot box (Collignon, 2004b).

Redistribution Function

Legitimacy issues also overshadow the redistribution function of Europe's public finances. It is usually agreed that, given the unequal initial distribution of resources, governments may correct market allocations in order to preserve norms of solidarity, justice, and fairness. The degree to which this is done remains open to debate. Technically, it is clear that a just state of distribution has to be derived from a social-welfare function and a tax-transfer constraint. But in practice, "the shape of the social welfare function as an instrument of social policy remains to be determined through the democratic process" (Musgrave, 1959: 46). Governments must intervene as they are the agents charged by citizens to enforce the norms of justice. Yet such interventions must be done by central governments. Tiebout (1956) has argued that, given free movement of factors of production, individuals will select the jurisdiction whose provision of local public goods and tax structures best satisfies their preferences. Lower-level governments may therefore create distorted incentives, leading to tax evasion as wealthier citizens move to low-tax jurisdictions (voting with their feet).[8] Drawing on the theory of fiscal federalism, Inman and Rubinfeld (1992: 657) therefore recommend "central government intervention" for redistributive policies.

Centralizing redistribution policies may also become necessary to strengthen the general acceptance and democratic legitimacy of European integration, as an unregulated single market may undermine traditional social models in the member states. With mobile households and a common citizenship, the marginal tax costs of income redistribution within each member state increases, as transfers by upper-income households to lower-income residents are likely to attract

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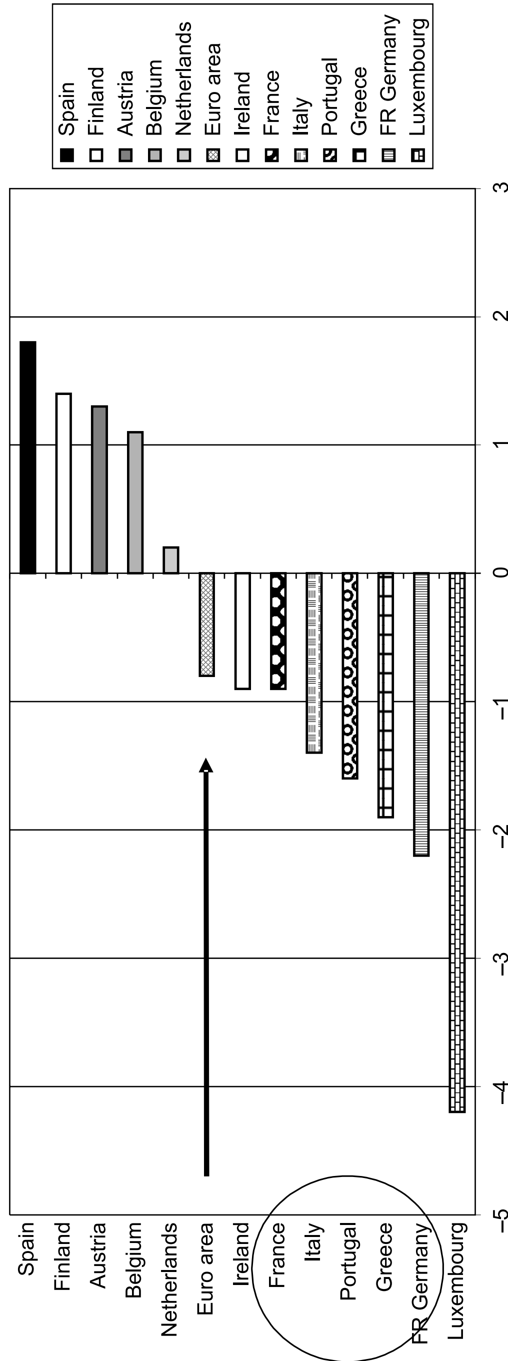

FIGURE 3. *Changes in Structural Deficits in Euroland 1999–2004*

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low-income immigrants from neighboring states. Hence, as high-income factors of production become more mobile, it will prove increasingly difficult for any state jurisdiction to achieve redistribution goals independently of other jurisdictions; attempts to redistribute within a jurisdiction will simply drive out mobile factors (Cullis and Jones, 1998: 304). This mechanism seems to have become a major threat to national welfare-state models in Europe since the arrival of a large number of new EU member states with low per capita incomes. It is feared that the freedom of movement for labor may lead to large-scale migration of workers and wage competition or to the reallocation of capital (delocalizations), leveling incomes not only by lifting poorer countries up, but also by bringing income in richer countries down. Thus, decentralized redistribution policies as practiced in the EU today are undermining not only national redistribution systems, but also the acceptability and legitimacy of European integration, as the failed referenda on the Constitutional Treaty in France and the Netherlands have demonstrated.

Furthermore, redistribution at the European level is essentially about redistribution of income between states, rather than between citizens. The Common Agricultural Policy apart, most intra-EU transfers are channeled through regional cohesion policies. Structural funds are targeted to regions where per capita income is less than 75 percent of the average EU per capita income. Cohesion funds were created in 1994 as an instrument for Ireland, Portugal, Spain, and Greece to manage the fiscal convergence of the Maastricht criteria. Today, they are aimed at financing inter-regional transport, infrastructure, and environmental protection in 13 countries whose per capita GDP is less than 90 percent of the EU average. Effectively, these funds work as a subsidy to national budgets. This is why negotiations about the multi-annual financial framework are always so acrimonious. National treasuries pay into the common kitty and look at how much they are "getting back." Margaret Thatcher succeeded in obtaining a rebate for Britain's contribution, but taxpayer resentment toward being a high net contributor is generally widespread in the EU. It was prevalent in the Dutch referendum and has dominated the German political discourse about Europe for a long time.

Legitimacy issues are highly sensitive in the domain of redistribution policies, as the trade-offs for wealth expropriation by taxes are fairness, justice, and solidarity – diffuse normative concepts rather than tangible benefits in terms of public goods.

Normative Foundations of Fiscal Policy in Europe

Legitimacy is a source of power (Collignon, 2003: 59–63). It is a necessary prerequisite for efficient fiscal policy, because without the collective acceptance of the actual choices or the general rules according to which individuals may be taxed and therefore deprived of their wealth, the optimal allocation of resources to collective preferences is not possible. Legitimacy draws on normative models of policy justification, which may lead to different institutional arrangements and policy outcomes. Eriksen and Fossum (2004) have crystallized three models of normative justification for the European integration process:[9] the EU as a problem-solving entity based on intergovernmental structures of governance and legitimized on technocratic grounds; a value-based community premised on a common European identity and appealing to communitarianism; and a rights-based political union based on a full-fledged political citizenship, which is close to what I have

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called a European Republic (Collignon, 2003, 2004d). Each of these concepts provides different justifications for EU fiscal policy. I will now link the different functions of public finance to these potential sources of legitimacy.

The EU as a Problem-Solving Entity

The first model focuses on efficiency and follows an instrumental and technocratic rationality. Legitimacy depends on the ability to solve problems efficiently and on the capacity to deliver public goods that people want. Scharpf (1999) has called this the model of output legitimacy. Tony Blair is probably its most prominent advocate. This doctrine focuses on tangible and material (net) benefits derived from EU membership. The European Union is conceived as a functional organization, not as a community of values or a public venture to manage common concerns. Cooperation, participation, and membership are premised on the ongoing calculation of costs and benefits. Thus, intergovernmental relations and strategic interactions between governments in search of maximizing advantages for their local and partial constituencies (Putnam's two-level game) dominate the interpretation of how EU policies should be defined.

This approach is well suited to the allocative function of fiscal policy. If resources are efficiently allocated, welfare is maximized and the policy must be optimal in terms of delivering the collective goods desired by citizens. Notice also that this interpretation necessarily assumes collective preferences as given, so that decentralized policymaking is welfare enhancing if preferences are heterogeneous. In other words, the EU as a problem-solving entity corresponds to the neoclassical and liberal paradigm of market autonomy and subsidiarity.

However, this approach leads to serious shortcomings if the decentralized provision of collective goods causes significant externalities with strategic substitutabilities. First of all, while the welfare-enhancing aspect of a problem-solving EU attracts new members, its capacity to deliver the desirable public goods to the union as a whole decreases and output legitimacy diminishes. As the number of decision-makers increases, collective action problems become more salient, at least in the domain of exclusive collective goods. As a consequence, output legitimacy in a problem-solving European Union tends to eliminate itself. Because efficient policy output is the only source of legitimacy in this model, there is no other criterion whereby the inflation of potential decision-makers could be contained. The EU will keep enlarging until the overall net benefits turn into a loss and there is a growing risk that the union will break up – first at the margin and then in a sudden collapse. The logic of such a development can be explained in simple neoclassical terms (North, 1981): while the net *benefit for new member states from joining* the EU is positive, the collective *benefit for old members from staying* in the EU diminishes due to increased transaction costs among many members. Hence, these externalities drive a wedge between the "individual" marginal cost of membership and the marginal "social" costs of accepting new member states, and this wedge undermines output legitimacy.[10] The answer would be to define property rights for these externalities, but this would imply a different cognitive framework[11] from that of the problem-solving EU. The model would have to incorporate explicitly collective preferences across the EU, something that the intergovernmental structure of the model does not permit.

Second, the shortcomings of the problem-solving approach are particularly severe with respect to stabilization policy. The new orthodoxy of "balanced

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budgets over the medium term" and automatic stabilizers as a cyclical adjustment mechanism would be welfare maximizing if all European citizens shared the same collective preferences and agreed that borrowing for public investment and higher consumption by the present generation was undesirable. However, there is no systematic reason why this should be the case. To the contrary. Time preferences, like all collective preferences, emerge from democratic debates and deliberations. As new evidence appears and is taken into account, debates change and preferences shift. Usually, public policy debates are centered on electoral contests for different government policies and leadership. Under the subsidiarity principle, the constituencies within which these debates take place are locally defined and do not cover all of the European Union's citizens. Hence, time preferences for allocating resources across time will reflect national policy debates, but not focus on what is in the common interest of all European citizens affected by the policy. Witness the example of France's deteriorating structural budget deficit after the re-election of President Chirac in 2002 (see Figure 3). The policy change reflected a commitment to the French constituency and pushed the aggregate euro deficit up. As a consequence, interest rates also went up (or at least not down), creating a clear negative externality for all other euro members. Because policy deliberation in Europe is confined to national constituencies, national preferences for structural deficits diverge across Euroland and the norm of balanced budgets stipulated by the Stability and Growth Pact will not necessarily correspond to the political preferences in all individual member states.

An effective stabilization policy implies that there is exactly one aggregate fiscal policy stance compatible with a monetary policy committed to maintaining price stability. But who is responsible for determining this equilibrium? There are two possible answers. First, if fiscal policy remains decentralized and determined at the national level, the aggregate European position is the sum of random national positions – at least within the 3-percent range of the excessive deficit procedure. In pursuit of macroeconomic stability, the Central Bank will then only be able to adjust interest rates passively to a level that is compatible with the *expected* aggregate budget outcome. In this case, monetary policy behaves as a Stackelberg follower[12] to a diffuse and random fiscal policy process of 12 governments. But the larger the random error around the mean aggregate position, the higher is the uncertainty for the ECB about the appropriate interest rate. Thus, monetary policy is likely to be slow in reacting to shocks and inefficient as a stabilization tool. Euroland's lackluster economic performance is therefore more likely to be a consequence of the institutional set-up for fiscal policy than of the specific policies chosen by the ECB. In fact, it is not even possible to speak of an EU stabilization *policy* in a proper sense, for a *policy* is defined as a sequence of deliberate decisions to maximize common objectives such as welfare, but in Europe there is no single elected agent responsible for making such deliberate decisions.

Second, an alternative to the decentralized model is to impose a general rule that will constrain individual member-state budget deficits and therefore define implicitly an aggregate fiscal policy stance. The SGP is such a rule, because if all member states keep their structural budget in balance, the aggregate structural deficit is zero. But this rule is not likely to reflect the changing preferences of all citizens as policy debates are confined to national constituencies. Of course, in nation-states, different views on the optimal fiscal stance may also exist. For example, in the USA, Republicans seem to prefer high deficits and high interest

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rates, and Democrats the opposite. But budget decisions are made by a unified government following the established democratic procedures. There is a *frustrated minority* which will attempt to realize its collective preference after winning the "next" election. In Europe, the aggregate fiscal stance is the result of the sum of decentralized decisions, each of which causes spillovers for all others through the effect that these decisions have on the common interest rate. In terms of collective preferences, the result is a *frustrated majority*. The resulting welfare losses reduce the output legitimacy of the SGP. The lesson is clear: the institutional reproduction of preference heterogeneity by Europe's splintered polity prevents sustainable, efficient, and democratically legitimate fiscal policies.

Deficiencies of the problem-solving approach to the EU also dominate redistribution policies, which largely take the form of cohesion policy. The legitimizing arguments for such technocratic redistribution policies are usually framed in terms of side-payments in intergovernmental negotiations or compensating losers of Pareto optimality. Rarely do they refer to normative concepts such as fairness and justice. For example, Germany's net transfers to the EU budget have long been considered a price well worth paying for the benefits obtained from participating in the single market. More generally, the funds flowing from richer to poorer countries were seen as a premium for peace and stability (Sinn, 1994). But again, if this is the only basis for justification, European cohesion policy stands on fragile feet. As the same sense of fairness and justice is not generally shared across all national constituencies, Thatcherite "rebate policies" will undermine the EU's capacity to "solve problems" regarding European public goods. Shocks to domestic preferences, such as German budget commitments after reunification in 1990, may also quickly change the relative position of costs and benefits. The legitimacy of EU redistribution policies and the sustainability of EU cohesion therefore remain based on a weak compromise, rather than on the solidarity of a collectively shared consensus.

We may conclude that the problem-solving model of the EU may have been suitable for legitimizing the early stages of integration, when shared public goods were still few in number and externalities were rare and limited. Output legitimacy is therefore well suited to international relations (Moravcsik, 2004). But as integration deepens, spillovers from national governmental decisions that affect citizens living in other member states of the EU will increasingly undermine output legitimacy. Preserving the process of European integration will then require additional sources of legitimacy.

Communitarian Sources of Legitimacy

An obvious additional source of legitimacy is a set of shared values. This cognitive framework is derived from common cultural background knowledge, which facilitates a coherent reinterpretation of individual preferences and their mapping onto the collective domain. As Eriksen and Fossum (2004: 442) put it: "to be legitimate a common identity is needed to secure *trust* ... Every political order presupposes some kind of cultural substrate to foster allegiance and respect for laws." In this communitarian perspective, "people" are turned into "compatriots" (brothers and sisters) with special bonds of solidarity. Communitarian legitimacy stems from primordial sources of belonging that constitute the identity of the group and provide the cultural substrate for collective decision-making (Miller, 1995, quoted in Eriksen and Fossum, 2004). Notice that, contrary to the technocratic

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problem-solving model, communitarianism is incompatible with methodological individualism; individuals are not defined as autonomous actors having desires, preferences, and interests, but by the common properties that define the group they belong to and codify the culture and to which individuals are bound and have to surrender. The bonds of solidarity within a community are the result of "weak" or "strong" ties between individuals, to use the classical distinction of Granovetter (1973). Strong ties contribute to the feeling of common identity, but have the further effect of loosening ties to other communities.[13] As a consequence, members of a community are "united in pursuing certain shared values" (Rawls, 2001: 20), but, at the same time, they become "loosely connected groups" with respect to other communities (Simon and Ando, 1961). Thus, communitarianism increases the probability of profound and irreconcilable differences in citizens' collective preferences and the possibility of inter-communitarian conflict. This is the opposite of what European integration is meant to achieve. Since Jean Monnet the essence of the "European idea" has been that creating links between individuals, notably through economic and commercial ties, will contribute to a form of "reasonable pluralism" (Rawls, 2001) based on toleration and acceptance of the other.

In Europe, the communitarian conception of policymaking has two dimensions. One such is the "Euro-nationalist" (Menéndez, 2005) or "European federalist" orientation, as it is more frequently called.[14] It seeks to create a European sense of community and identity by focusing on what unites European citizens. The other variant is the Euro-skeptic attachment to the national community and the traditional nation-state, thereby focusing on what divides. A communitarian conceptualization of the European Union emphasizes the set of moral values shared by all European citizens (Menéndez, 2005). Usually, these are positive norms to which general agreement is easily obtained. The Constitutional Treaty in Article I-2, for example, emphasized the role of common values such as human dignity, freedom, democracy, equality, human rights, tolerance, justice, and solidarity. But Helmut Schmidt (2000: 209) has pointed out that "common errors and sins" are also part of the European cultural inheritance: crusades, anti-Semitism, the inquisition, the burning of witches, torture, and wars of conquest, plunder, and destruction. All these positive and negative historical experiences have created a cognitive framework from which a "We-feeling" among Europeans has emerged, although the intensity of this feeling may not be shared equally among all citizens and often competes with national identities. The sense of European identification is regularly measured by Eurobarometer. Figure 4 gives an indication of the strength of Euro-nationalism relative to traditional nation-state identification. The strength of identification with the cultural substrate of the nation-state is measured by the number of citizens that see themselves either exclusively as citizens of their own country or first as citizens of their own country and then as Europeans. I have regrouped under Euro-nationalism all other responses that do not give priority to a national state identity. Some 85 percent of all European citizens show strongest identification with their own nation-state, 37 percent exclusively so. Only 14 percent consider European citizenship to be equal to (7 percent) or more important than (4 percent) their national identity. Some 3 percent identify themselves as being exclusively European.

What are the implications of communitarianism for fiscal policy? For Euro-nationalists, policy centralization at the European level is required in order to

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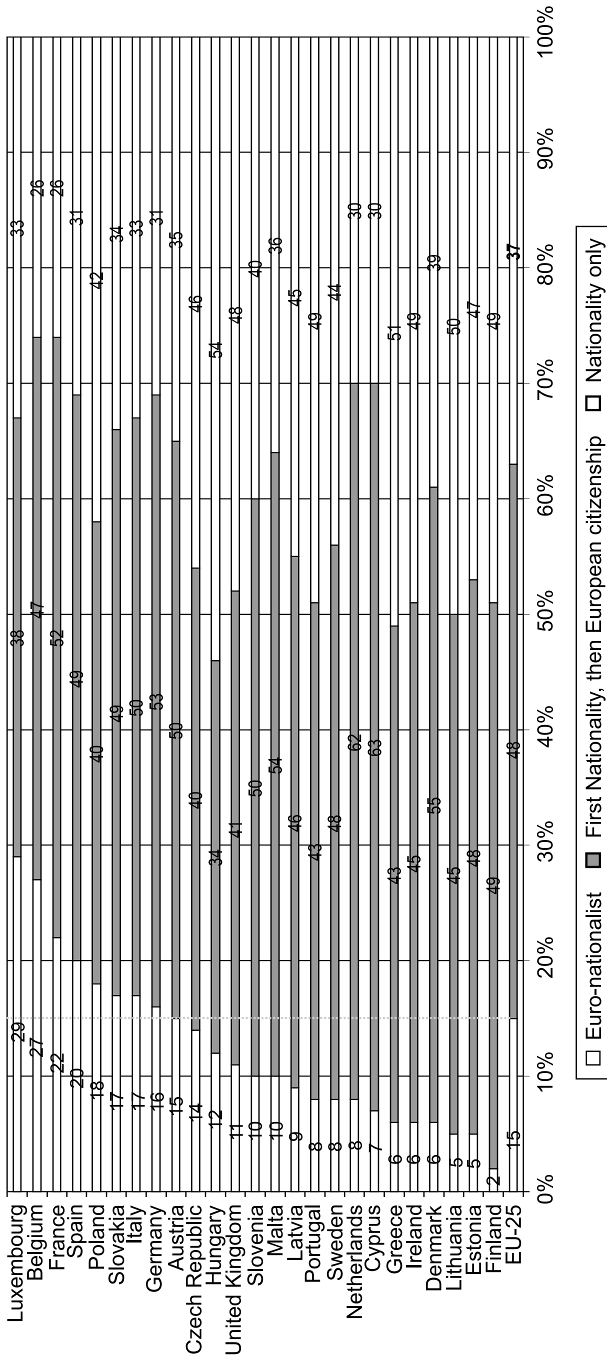

FIGURE 4. *Citizenship Feeling in the EU*

Source: Eurobarometer (2004).

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defend common European values. For fiscal policy this implies a large US-type federal budget, as advocated in the MacDougall Report (1977), or at least an expansion of the EU budget to provide common goods, such as European security and defense policies, protection against terrorism, and more spending on research and development or education (knowledge society). It seems relatively easy to find agreement for public spending priorities in these policy areas and the allocation of resources to these ends would be welfare optimizing. With respect to stabilization policy, Euro-nationalists generally focus more on external equilibrium and the international dimension of the euro than on matters of internal efficiency. This results from the fact that communitarians consider the community as a "whole," rather than the individual parts and their interactions. Thus, speaking with one voice and acting as one actor in international institutions, such as the International Monetary Fund, World Bank, the G7, and so on, is one of their major concerns. Given that there is no large federal budget in Europe, Euro-nationalists seek at least to improve the coordination of fiscal policies in the context of the multilevel governance found in the euro group. The fact that this forum for intergovernmental policy coordination receives no directly legitimizing input from European citizens does not seem to weaken its legitimacy, given that the desirability of policy coordination is value based. Similarly, Europe-wide redistribution policies seem legitimate from this point of view, as solidarity within the EU, and more specifically between rich and poor countries, is based on moral or ethical imperatives derived from shared knowledge of what is the common good.

However, the communitarian conception of the EU as a provider of legitimacy is handicapped by some serious drawbacks, which are reflected in the Euro-skeptical position. By deriving legitimacy from a "primordial belonging," communitarians necessarily focus on what Habermas (1988) has called the "living world" (*Lebenswelt*) that "is always already there." In other words, the communitarian view draws legitimacy from conventions and norms that are consensual common knowledge within given communities. Notice that collective preferences are again exogenously given in this model – as they were in the problem-solving interpretation. But in the European context, the "community," within which conventions are shared, is predominantly the *nation*. As Habermas has shown, the sense of "We-feeling" in nation-states, particularly in the form of "constitutional patriotism," is to a large degree a function of the mechanisms of political deliberation and the institutions of democracy. Thus, given that the European Union has been founded by nation-states with (mostly) long histories, a value-based Europe is necessarily characterized by deep value pluralism and by conflicting views of the common good within and among groups, local communities, and cultures (Eriksen and Fossum, 2004: 443). The historically and institutionally determined preference heterogeneity is significantly more persistent between nations than within nation-states, because the EU does not have the same institutional depth for political deliberation that creates strong ties and characterizes democracy in nation-states. From a Rawlsian perspective, one may argue that European preference heterogeneity is perfectly compatible with "reasonable pluralism," provided it is supported by "overlapping consensus." However, the emergence of overlapping consensus requires that citizens justify to one another their political judgments and convince each other by public reason (Rawls, 2001: 27–32). But the segregation of European policy debates into divided national polities prevents the justification of a European

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public reason. It is therefore the institutional structure of policy debates about European public goods that prevents the emergence of a common political will and shared preferences.

Communitarian models of legitimacy privilege nationalist policymaking solutions over European ones. Democracy is thought to be dependent on a culturally homogeneous, pre-existing "demos" and not on procedures to come to acceptable choices on public goods. This fact poses serious problems for the conduct of European fiscal policies. It calls for the allocation of resources to public goods to be decentralized, and subsidiarity becomes the dominant principle. Europe does not seem to have a right to get involved with the wishes and preferences of local citizens. The fact that these local decisions may have spillover effects on other constituencies and cause collective action problems is cognitively blended out, because the coherence of the value-based approach to policymaking requires *ignoring* ("tolerating") the validity of other value systems. Thus, if "our" country likes low taxes and "yours" likes high taxes, so be it. But the systemic inconsistency of the two attitudes coexisting within the same economy, so clearly described by Tiebout (1956), does not legitimize more efficient, centralized European policies.

From a communitarian point of view, decentralization appears welfare enhancing, but from a problem-solving perspective, it is inefficient, because subsidiarity increases collective action problems. This dilemma is even magnified with respect to stabilization policy. As government borrowing necessarily affects conditions in the capital market and the equilibrium position of the policy mix between the unified monetary policy and the aggregate fiscal stance, externalities in the form of interest and exchange rate levels or inflation are instantaneous and omnipresent. It is therefore only logical if Euro-skeptics refuse to join the European Monetary Union, as the primacy of national policy preferences is incompatible with macroeconomic policy stabilization at the European level. But by opting out of the EMU, Euro-skeptics also sacrifice the efficiency gains obtained from a single currency in a single market. With respect to redistribution policy, the Euro-skeptical communitarian approach emphasizes lack of solidarity, given the absence of a European demos. But this is in fact only the mirror image of nationalistic communitarianism. Thus, Euro-skeptic communitarians claim that a sufficient degree of solidarity for legitimizing European redistributive policies does not exist.

As we have seen, the main answer given by communitarians to the problem of preference heterogeneity is decentralization, but this reduces output efficiency. Thus, there is a trade-off between efficiency and legitimacy in Europe. Yet, contrary to Alesina and Waczirag (1999), I have argued (Collignon, 2003) that the trade-off curve is not stable, but can be shifted by unifying the polity and adjusting the range of competences to the dimension of policy externalities. In other words, when citizens are entitled to choose a European government for administering the public goods that affect them all (and only those), then they will deliberate collectively about those policies and that opens the possibility that they can go beyond the established conventions of their living world and find an overlapping European consensus. Thus, political democracy at the European level would contribute to forming a trans-European policy consensus that will gradually become the "cultural substrate" for European decision-making. This idea opens the way to the third model of normative justification for the European integration process.

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The European Republic Approach

The technocratic legitimacy of a problem-solving European Union and the communitarian legitimacy of a value-based Europe both implicitly assume collective preferences as exogenously given. Legitimacy is then generated by adapting policies to these preferences, either by maximizing efficiency or by minimizing centralized decision-making. Both approaches have their limits, as we have seen. We will now look at the third model for justifying EU policymaking, in which preferences are changed and altered as a consequence of communication and deliberation (Dryzek, 2000; Elster, 1998; Shapiro, 2003). Eriksen and Fossum (2004) have related this deliberative strategy to the rights-based procedural notion of legitimacy based on full-fledged political citizenship. It implies reflexively organized learning that is structured by constitutions and brings together knowledge and normative perspectives in order to establish mutual understanding and agreement (Erikson, 2005: 17). Transcending the traditional holism of communitarian preference homogeneity, modern constitutions enshrine respect for the integrity and dignity of *individuals*.[15] The plurality of individuals means preference heterogeneity is all-pervasive and disagreements "should be settled by argument and be reflected in the working principles of the polity" (Eriksen and Fossum, 2004: 443). The assumption of methodological individualism requires that collective agreement is something that individuals choose. But this choice is constrained by fundamental norms and institutions (Rawls's "basic structure"). In modern societies, it is the contractual principles of market economies that provide the normative foundations for economic and political freedom and equality (Collignon, 2005). They entail rights for protecting the integrity of the individual (private freedom) and for enabling individuals' participation in public opinion formation and the decision-making process (public freedom). The conjunction of these private and public freedoms allows democracy to function as a process of deliberation between free and equal citizens. Democracy as a deliberative procedure for reaching acceptable collective decisions is therefore a source of legitimacy. With respect to Europe, I have called this normative approach to European integration the European Republic to distinguish it from the communitarian federalist model (see Collignon, 2003: Ch. 4).

However, modeling the process of deliberation has been a challenge. For many writers who pledge allegiance to deliberative democracy, deliberation seems only to work in relatively homogeneous groups who share many values and beliefs, while pluralism would undermine the possibility of agreement and consensus. Such a concept of deliberation is reminiscent of the Aristotelian version of civic republicanism, which emphasized citizens' direct participation in the process of government (Sunstein, 1985; Wood, 1998). It also goes back to Habermas's (1988) "ideal speech situation," which describes a normative set of ideal conditions for individuals agreeing with each other. However, the size and complexity of modern society seems to make most of these accounts of deliberation "unrealistic, if not quaint" (Bohman, 1996: 2–3). In *The Federalist Papers*, Madison and Hamilton (Hamilton et al., 1999) gave a convincing account of why republicanism is not dependent on small communities, but can actually work better in large representative democracies.[16] The essence of modern republicanism is that the republic belongs to citizens rather than the crown – citizens are the sovereign. This is the fundamental paradigm shift accomplished by the American and French revolutions.

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But this new paradigm also implies that the republic becomes a matter of deliberation (Nicolet, 1994: 32–4), for the word "republic" is understood to mean "the public good" – the *res publica* (Paine, 1999). However, the definition of what the public good is, hence what people consider as their collective utility, requires some form of common consent. This consent does not necessarily imply unanimity; rather, it reflects the idea expressed by Benjamin Franklin (1993) in the ratification debate of the US Constitution: "I consent ... to this Constitution because I expect no better, and because I am not sure that it is not best." Based on previous work by DeGroot (1974) and Lehrer and Wagner (1981), I have formalized this idea in the concept of stochastic consensus (Collignon, 2003; Collignon and Al-Sadoon, forthcoming and Collignon and Schwarzer, 2002). It shows that face-to-face communication or ideal speech situations are not necessary conditions for deliberation (although they are sufficient conditions).

The theory of stochastic consensus proceeds in three steps. Preferences are modeled as states of mind that occur with certain probabilities (the preference intensity). These probabilities are conditional on (1) predetermined circumstances (comparable to Habermas's *living world*), (2) *reflective equilibrium*, in which individuals work out autonomously what they consider the best option (comparable to Rawls's concept), and (3) a process of communication in which they take into account what others think because they know they do not know everything (*bounded rationality* à la Simon). Steps (1) and (2) are inputs for the public process of deliberation in step (3), where individuals revise their previous probability assessments. It can be shown that all individuals in a society will converge after many rounds of deliberation toward the equilibrium situation in which they all have the same probability of accepting a preference (same preference intensity) provided two fairly weak conditions are met: (1) mutual respect and (2) connectedness. Mutual respect arises when all individuals have some doubt about the validity of their own opinions and therefore look at the views held by people they trust and respect.[17] If people were entirely convinced that they are always right, society would collapse into a Hobbesian "*State of warre*," in which neither consent nor agreement on public goods would be possible. Connectedness means that all individuals are linked by a chain of respect so that in the process of deliberative communication every person will ultimately influence everyone else, even if the impact is infinitesimally small. The connectedness condition assures that all information is optimally distributed in equilibrium (according to people's subjective assessment).[18] Note that this does not require direct face-to-face contact and therefore provides an alternative to the rather unrealistic assumptions of the ideal speech situation. Given these minimal conditions, communication in society will transform individuals' values and preferences and make them converge toward a policy *consensus* that is eventually accepted and shared by all. It is easily perceived that these weak conditions are fulfilled in most modern societies and, specifically, in the European Union.[19] However, the theory of stochastic consensus also reveals that *dissent*, the stochastic noise around the emerging equilibrium, and its persistence will depend on the institutions which structure the process of deliberation and policy debates. For example, in loosely connected groups, convergence toward policy consensus is rapid within communities, but slow between them. The reason is that in communities information circulates rapidly through strong ties, while it may jam at the weak ties. Overcoming communitarian blocks in European policy preference formation therefore requires a denser and more

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balanced structure of policy deliberation. The simulation in Annex I of my book *The European Republic* (Collignon, 2003) indicates that dissent is more persistent in the EU's intergovernmental policy arrangement than in a federal republic.

This means that the procedural arrangements in EU policymaking determine not only the ranking of collective preferences, but also the persistence of preference heterogeneity and pluralism. Justifying EU policymaking by deliberative democracy is therefore complementary to the technocratic approach of a problem-solving EU. But with respect to the communitarian approach, it is only compatible with the Euro-federalist view, and not with the Euro-skeptical view. The procedures of a proper European democracy, in which European citizens elect a European government, would intensify policy debates across the entire European polity and thereby increase the connectedness of individual citizens and raise the level of cross-border trust.[20] This would accelerate the emergence of a pan-European policy consensus and reduce preference heterogeneity in the EU, at the price of altering the local *living worlds* that have "always already been there." Eriksen and Fossum (2004: 448) are therefore right when they write that "the demos is to be shaped by political means; hence there can be no European demos without a European democracy." By contrast, the intergovernmental model confines policy debates to national polities. In the European context, the nation-state is therefore transformed into a communitarian device that maintains dissent, and possibly leads to conflict.

What are the implications of a European Republic for the legitimacy of fiscal policy? By "European Republic" I refer to a political union with full democratic legitimacy responsible for administrating European public goods, somewhat along the lines of what the Belgian Prime Minister Guy Verhofstadt (2006) has called the "United States of Europe." It transcends a political union between governments in which legitimacy is a derivative of the nation-state, as under the Treaty of Nice or the European economic government suggested at one stage by French authorities. In the European Republic, citizens and not states are sovereign. Citizens must jointly deliberate what they consider to be their common good. As I have said before, European public goods are those (and only those) that affect all citizens living in the EU and a European government should have exclusive authority for these and only these goods. This is why a European democracy requires a government elected by universal suffrage and in charge of articulating preferences and executing policy choices. By being politically accountable and having to verify its legitimacy through regular EU-wide elections (for example, for the European Parliament), political deliberation finds the focus which is necessary for the rapid emergence of a European policy consensus.

What does this model tell us about the legitimacy of fiscal policy? For the allocative function of public finance it implies that European-wide deliberation on the allocation of resources to European objectives will be backed by democratic consensus. This applies both to the potential size of the EU budget as well as to the prioritization of its content: whether money is spent, say, on the Common Agricultural Policy or research and development is then a matter of policy preferences debated by citizens, rather than the result of compromises and side-payments between governments. From this point of view, deliberative democracy is welfare enhancing, because it simultaneously reduces preference heterogeneity and legitimizes the internalization of externalities.

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A similar argument can be made for redistributive policies, which, according to the literature on fiscal federalism, should be centralized at the European level. The structures of democratic policy debate in the EU would contribute to the transformation of citizens' identification with their home country and European citizenship. Thus, democracy in the European Republic is likely to increase the sense of solidarity across Europe, because weak ties between nations would become stronger and strong ties within nations would weaken. As a consequence, it should be possible to break the traditionalist communitarian feeling of "belonging" and, instead, replace it with a modern sense of solidarity between free and equal individuals.

With respect to stabilization policy, the European Republic would allow an elegant solution to the dilemma that the allocation of resources should be decentralized according to principles of subsidiarity, while it is the aggregate fiscal stance at the European level that is required as a counterpart to monetary policy. We have seen that an active fiscal policy approach should entail the possibility of defining the long-term (equilibrium) positions of (structural) fiscal deficits reflecting collective time preferences. With today's political institutions this is not possible, but under the European Republic approach, the European government would be charged with defining the aggregate stance. This policy would reflect deliberations between European citizens, because otherwise the European government may not be re-elected. Technically, this aggregate budget position would be formulated as a European law, for example, as a modified form of the Broad Economic Policy Guidelines[21] or what Amato (2002) has called in reference to the Italian budget procedure a "*DPEF europeo.*" Once this budget stance has been approved by the European Parliament and the Council, each member state obtains tradable deficit permits, which reflect each government's entitlement to borrow in the capital market (Casella, 2001; Collignon, 2004c).[22] Without these permits, access to the market is barred. If one government or jurisdiction wishes to borrow more than its assigned quota, it would have to buy deficit permits from other governments who do not wish to use up their quota. This procedure would guarantee that national borrowing remains consistent with the aggregate fiscal stance, which is the relevant reference for the central bank's setting of interest rates. The advantage over the Stability and Growth Pact is that the aggregate stance is more easily foreseeable for all economic agents. The uncertainty that weighs heavily on the ECB today would be lifted, thereby allowing a more active and efficient monetary policy. The legitimacy of stabilization policy in general and the ECB in particular would be increased.

Conclusion

The way different policies are justified to obtain agreement affects policy outcomes. This is the basic message of this article. But legitimacy is also structured by institutions, and different sources of legitimacy privilege different institutional arrangements. The technocratic interpretation of the European Union as a problem-solving organization may have been appropriate in the early years of integration, but its previous success may now lead to its demise, as the cost of collective action problems are wiping out the efficiency gains of the single market. The communitarian justification of integration on the basis of shared European values can certainly contribute to increased legitimacy of the EU, but by focusing

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on communitarian values Europe is more likely to emphasize what divides than what unites it. In addition, communitarian decentralization further reduces the efficiency of Europe's technocratic governance and therefore risks reducing the EU's overall legitimacy. Methodologically, these two sources of legitimacy assume political preferences as given; therefore they cannot explain which institutions are required to lift the collective level of acceptance of European policies. A deliberative approach to legitimacy allows going beyond these limitations and additional legitimacy to be generated by creating a political union with full democratic procedures; I have called such a union the European Republic.

Fiscal policy is at the core of political legitimacy. Exclusive reliance on either the technocratic or the communitarian models of legitimacy prevents designing a coherent fiscal policy for Europe that would be efficient in the welfare-augmenting sense. By taking the next step and submitting some functions of fiscal policy, especially stabilization policy in the euro area, to the democratic legitimacy of a European government, Europe would not only become more attractive to its citizens, but its economic performance would also be improved.

Notes

1. Knut Wicksell (1896) was the first to recognize that the rule of unanimity for reaching collective decisions provides the institutional analogue to two-person trade in strictly private or partitionable goods. The theme was later rediscovered by Buchanan (1975).
2. Rawls (2001: 3) has defined communities as "a body of persons united in affirming the same comprehensive, or potentially comprehensive doctrine" (which covers our concept of collective preferences) and goes on to emphasize that "while we can leave communities voluntarily ... there is a sense in which we cannot leave our political society voluntarily" (2001: 20).
3. He recommended taxation for building institutions, which "though they may be in the highest degree advantageous to a great society, are, however, of such a nature that the profit could never repay the expense to any individual or small number of individuals and which, it, therefore, cannot be expected that any individual or small number of individuals should erect or maintain" (Smith, 1976: 723).
4. All data used in figures in this article are taken from the AMECO database of the European Commission DG ECFIN unless otherwise indicated.
5. The 10 member states are Malta, Estonia, Latvia, Cyprus, Lithuania, Luxembourg, Slovenia, Slovakia, Hungary, and the Czech Republic.
6. This is a statement of normative validity, not of empirical truth. No doubt, a large single market can tolerate some small free-riders who do not share the same currency, but benefit from the single market's stability. Euroland represents nearly three-quarters of the EU's GDP, even after enlargement to 25 member states. On the other hand, it was certainly no coincidence that the switch from bimetallic standards to the gold standard in the late 19th century was characterized by rapid economic growth. See Bordo (1999: 159).
7. As Oates (2004: 26–7) points out, "decentralised levels of government focus their efforts on providing public goods whose consumption is limited primarily to their own constituencies. In this way, they can adapt outputs of such services to the particular tastes, costs, and other circumstances that characterise their own jurisdictions." Thus, in this decentralizing theory of fiscal federalism, which Europeans call subsidiarity, there is no place for the spillover of public goods into other constituencies. In Collignon (2003), I have argued that this model is not suitable for policy analysis in the European Union, where spillover effects are widespread. Many collective goods are consumed by all European citizens, although there are no institutions to match policy output with democratic policy input.

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8. The most extreme form of imposing externalities on other groups is so-called systemic or regulatory competition. Assume a large group of citizens vote with their feet for lower taxes by moving into a low-tax jurisdiction. This imposes tax cuts on a high-tax jurisdiction, which is in danger of losing its tax base. As a consequence, voters who would have preferred a larger public sector are forced to put up with a policy choice that does not correspond to their preferences. But, of course, the opposite externality accrues for those who do not want to pay high taxes, but stay in a high-tax jurisdiction.
9. See also Eriksen (2005).
10. For a formal model of this logic, see Collignon (2003: Annex 2).
11. North (1981) discusses such cognitive frameworks under the notion of ideologies.
12. In a sequential game, a Stackelberg follower always makes the second move.
13. This interpretation of weak and strong ties is implied by my theory of stochastic consensus (see below), whereby a tie reflects the likelihood of accepting another's opinion. The strength of ties is a probability measure between zero and one, and all ties together add up to one. Therefore, if intra-community ties have a high weight, extra-community weights must be low. The strength of ties also turns out to be crucial for explaining dissent and the speed of convergence toward consensus in a society which starts out with heterogeneous preferences, but remains open to learning and interactive deliberation. See Collignon and Al-Sadoon (forthcoming).
14. I have taken issue with the communitarian concept of federalism in Europe, as it is historically linked to the anti-cosmopolitan view of a "closed society" and promotes the hypertrophy of "subsidiarity." See Collignon (2003: Ch 4).
15. Notice the dramatic shift from communitarianism, which protects the integrity of nation-states and treats individuals as an abstract cultural code.
16. See, notably, Hamilton et al. (1999: Papers Nos 9 and 10).
17. Mutual respect does not imply equal respect, but simply that there is a chain of respect between individuals that permits information and arguments to be exchanged and accepted to varying degrees among all individuals. See Collignon (2003); Collignon and Al-Sadoon (forthcoming). If individuals have no self-respect and do not diversify their sources of information, consensus becomes a cascade (all end up thinking what the "early movers" were thinking). See Sunstein (2003).
18. One may object that cascades, fads, bandwagon effects, and so on may not produce optimal outcomes. This is correct, but they only occur when our basic assumptions are violated. The fact that they usually do not last long is proof that they are not a rational equilibrium.
19. An objection raised by an anonymous referee is that increased connectedness may alienate individuals. Political debates sometimes polarize, leading to increased distrust. This may occur when people's assessment of individual opinions is dependent on the deliberation process itself. Technically, preference formation will then follow a nonhomogeneous Markov process. In this case, one has to specify how individuals change their assessment matrix. Lehrer and Wagner (1981) have shown that such processes will also converge toward consensus. Polarization implies a violation of the basic conditions. If consensus on policy issues is impossible, constitutional consensus on procedures for decision-making (for example, majoritarian voting) may still be viable. Unfortunately, I do not have the space to discuss this in greater detail.
20. I have analyzed the impact of the institutional arrangement of connectedness on European policy consensus in Collignon (2003) and the role of trans-border generation of trust in Collignon and Schwarzer (2002).
21. It would be modified in form because accountability to citizens implies that it is the European Parliament and not exclusively the Council that should debate and pass this law.
22. Member states may devolve these deficit permits to local authorities and thereby reinforce fiscal discipline at lower government levels.

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